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DIRECTORATE-GENERAL FOR ECONOMIC AND FINANCIAL AFFAIRS

BROAD ECONOMIC POLICY GUIDELINES AND CONVERGENCE REPORT

No 55 1993

European Economy appears twice a year. It contains important reports and communications from the Commission to the Council and the Parliament on the economic situation and developments. As a complement to *European Economy*, the series *Reports and studies* will be published on problems concerning economic policy.

Two supplements accompany the main periodical:

- Series A—'Economic trends' appears monthly except in August and describes with the aid of tables and graphs the most recent trends of industrial production, consumer prices, unemployment, the balance of trade, exchange rates, and other indicators. This supplement also presents the Commission staff's macroeconomic forecasts and Commission communications to the Council on economic policy.

- Series B—'Business and consumer survey results' gives the main results of opinion surveys of industrial chief executives (orders, stocks, production outlook, etc.) and of consumers (economic and financial situation and outlook, etc.) in the Community, and other business cycle indicators. It also appears monthly, with the exception of August.

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Commission of the European Communities

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Broad economic policy guidelines and convergence report

Abbreviations and symbols used

Member States

B	Belgium
DK	Denmark
D	Germany
WD	West Germany
GR	Greece
E	Spain
F	France
IRL	Ireland
I	Italy
L	Luxembourg
NL	The Netherlands
P	Portugal
UK	United Kingdom
EUR 9	European Community excluding Greece, Spain and Portugal
EUR 10	European Community excluding Spain and Portugal
EUR 12−	European Community, 12 Member States including West Germany
EUR 12+	European Community, 12 Member States including Germany

Currencies

ECU	European currency unit
BFR	Belgian franc
DKR	Danish krone
DM	German mark (Deutschmark)
DR	Greek drachma
ESC	Portuguese escudo
FF	French franc
HFL	Dutch guilder
IRL	Irish pound (punt)
LFR	Luxembourg franc
LIT	Italian lira
PTA	Spanish peseta
UKL	Pound sterling
USD	US dollar
SFR	Swiss franc
YEN	Japanese yen
CAD	Canadian dollar
ÖS	Austrian schilling
R	Russian rouble

Other abbreviations

ACP	African, Caribbean and Pacific countries having signed the Lomé Convention
ECSC	European Coal and Steel Community
EDF	European Development Fund
EIB	European Investment Bank
EMCF	European Monetary Cooperation Fund
EMS	European Monetary System
ERDF	European Regional Development Fund
Euratom	European Atomic Energy Community
Eurostat	Statistical Office of the European Communities (SOEC)
GDP (GNP)	Gross domestic (national) product
GFCF	Gross fixed capital formation
LDCs	Less-developed countries
Mio	Million
Mrd	1 000 million
NCI	New Community Instrument
OCTs	Overseas countries and territories
OECD	Organization for Economic Cooperation and Development
OPEC	Organization of Petroleum Exporting Countries
PPS	Purchasing power standard
SMEs	Small and medium-sized enterprises
toe	Tonne of oil equivalent
:	Not available

Contents

[1] This document has been prepared under the sole responsibility of the Directorate-General for Economic and Financial Affairs.

[2] This document was adopted by the Commission and transmitted to the Council, which discussed it on 13 and 16 December 1993, and to the European Parliament. Chapter I on economic and monetary convergence and Chapter II on the assessment of the internal market were prepared by the Directorate-General for Economic and Financial Affairs and by the Directorate-General for the Internal Market and Financial Services, respectively.

Foreword

1. With the entry into force of the European Union Treaty on 1 November 1993 and the commencement of Stage II of EMU on 1 January, the Community has at its disposal new tools for a strengthening of the coordination process. Provided that these new instruments are implemented and used in an efficient way, the Community can make a quantum leap in the effectiveness of its economic policy coordination.

This encouraging prospect of a strengthened coordination process contrasts with the economic problems presently facing the Community and with the ensuing fears about the feasibility of achieving the Community's main medium-term policy objectives by say 2000. The 1993 recession, high and steadily rising unemployment, worrying deteriorations in budgetary positions and the protracted ERM turbulence, all testify to the fact that the Community has been experiencing difficult economic times. However, there is no reason to be unduly pessimistic. The Community has passed the trough of the recession and a recovery is in the offing while further progress is being made towards a downward convergence of inflation and interest rates. During the recovery process, it will be crucial to intensify budgetary consolidation. By adopting the December 1993 broad economic policy guidelines, the Community has at its disposal a macroeconomic frame of reference which spells out a strategy conducive to sustained non-inflationary growth, high employment creation and improved nominal and real convergence. If resolute and early action is taken to first implement and then to adhere to these guidelines, there is a chance of returning, over the next few years, to a sound and durable growth path with markedly falling unemployment and progress towards convergence, thereby fulfilling the conditions for a successful transition towards the final stage of EMU within the time span stipulated in the Treaty.

2. Of course, success will crucially depend on Member States' commitment as they retain ultimate responsibility for their economic policies. However, under Article 103 of the Treaty they are required to regard their economic policies as a matter of common concern and are obliged to coordinate them within the Council. In this coordination process, a crucial role is attributed to the periodic establishment by the European Union of broad guidelines for the economic policies of the Member States and of the Community (Article 103(2)). In effect, these policy guidelines will constitute the reference framework for the conduct, and regular monitoring and assessment by the Commission and the Council, of the economic policies of each of the Member States and of the Community. In the event of an established inconsistency of national economic policies with the adopted guidelines, the Treaty provides for the possibility of addressing a specific — confidential or public — recommendation to the Member State in question (Article 103(4)). It is to be hoped that the number of occasions on which the Council will be obliged to make such recommendations will be limited and that the self-interest of Member States and normal peer group pressure at the Community level will be sufficient to elicit the necessary policy adjustments.

3. To highlight their concern with the Community's difficult economic situation and with the need for progress towards greater convergence of economic performances and policies amongst Member States, both the Commission and the Council wished to initiate the application of these Treaty provisions

as quickly as possible. An adoption of the first broad guidelines before the end of 1993 was also warranted to mark the transition to Stage II of EMU in January 1994. In effect, the Council (economic and financial affairs) formally adopted the first broad economic policy guidelines on 22 December 1993.

In this context, it should be noted that for the adoption of the guidelines the Treaty lays down a procedure consisting of several steps. According to the Treaty provisions, the Council (economic and financial affairs), acting on a recommendation from the Commission, formulates a draft for the broad guidelines for economic policies and reports its findings to the European Council. The latter, which has a particular responsibility for the overall coherence of the Community's economic policy, discusses a conclusion on the guidelines before they are formally adopted by the Council (economic and financial affairs) in the form of a recommendation. On the other hand, the interactive nature of the procedure involving all the key players is of paramount importance. The guidelines which are finally adopted represent both a distillation of, and a consensus on, the most appropriate macroeconomic and microeconomic policy framework to be adhered to in both the Community and in the individual Member States.

4. In relation to the 1993 guidelines exercise, it is important to stress the exceptional nature of this year's practice. Since this was the first application of a new procedure, a framework document — which acted as an explanatory background paper — was approved by the Commission and discussed by the Council (economic and financial affairs). It also received a favourable opinion from the European Social Partners. Another specificity of the December 1993 guidelines is that they contain a blend of policy recommendations for the short, medium and long term.

As regards future guidelines, the established economic policy framework is likely to remain valid over a number of years. It is, however, conceivable that future guidelines will focus more on short-term and short to medium-term aspects and be more concrete concerning individual Member States, especially in the budgetary field. In addition, it is the Commission's intention to start the guidelines process in the future with the publication of its own Annual Economic Report in late winter/early spring. It would serve as an analytical background document, containing an assessment of past, current and prospective developments in the Community's economy and the Member States as well as a discussion of the available policy options. This would allow both the Parliament and the Economic and Social Committee to formulate an opinion which the Commission would consider when drafting the recommendation for the guidelines. Under this procedure, the broad guidelines would be submitted to the June European Council. This would enable national governments to take them into account in the elaboration of their budgets.

5. The Commission has attached particular importance to the December 1993 broad guidelines exercise for several reasons.

Firstly, as the initial implementation of a new procedure it will have an impact on the way the exercise will be carried out in the future.

Secondly, although it concerns two clearly distinct exercises, there is a close link between the broad guidelines and the Commission's White Paper on

'Growth, competitiveness and employment'. In effect, the guidelines provide an early translation into operational policy recommendations of the macroeconomic and some structural actions suggested by the White Paper; simultaneously, they constitute the macroeconomic frame of reference for the White Paper.

Thirdly, by recommending a committed and concerted strategy, the guidelines bestow the coordination process with a clear content — for the first time in Community history. In effect, more than just calling for a stable macroeconomic framework, the December 1993 guidelines embrace an explicit strategy, for sound growth and employment creation, to be followed in the key areas of monetary policy, budgetary policy, labour market policy and structural adjustment. As a result, the guidelines should enhance the effectiveness of existing coordination instruments. In effect, the guidelines will form the central core of future multilateral exercises. The broad framework underlying Member States' convergence programmes as well as their implementation will be evaluated by reference to the strategy recommended. As such, the guidelines endow the Community with a clear yardstick to measure the degree of political commitment which Member States attach to the Community's short-term and medium-term policy objectives.

Finally, the Commission was very keen on seeing the philosophy and key ingredients of its framework endorsed by the Council and the European Social Partners. Not only because it is convinced that the strategy it proposed was the most appropriate to overcome the Community's present economic recession and to achieve, in a medium-term perspective, the Community's main objectives as stipulated in Article 2 of the Treaty, but also because it considers that a consensus on the appropriate future course of economic policies in the Community will contribute to the restoration of economic agents' confidence and facilitate the acceptance of some sacrifices that certain measures will inevitably entail.

6. Turning briefly to their economic-policy content, not surprisingly the December 1993 guidelines confirm that the present poor employment/unemployment performance and inadequate growth in the Community constitute the core economic policy problems. By adopting the guidelines, the Community has set itself the ambitious objective of making significant inroads, over the medium term, in reducing the number of unemployed, presently standing at the unacceptable level of 17 million. In this context, the Commission has tentatively put forward the target of creating at least 15 million new jobs, thereby halving the present rate of unemployment by the turn of the century.

To realize this objective, high rates of employment creation must be achieved and maintained over many years. This calls for a strategy which aims at generating a substantial increase in both the rate of economic growth and its employment content. The strategy recommended fulfils these requirements. It basically consists of three interrelated elements.

The creation and maintenance of a stable macroeconomic framework. This implies that a rate of inflation of no more than 2 to 3% should be reached in most Member States by 1996. Achieving this target implies that all policies and behaviours should be consistent with this objective. Lack of such coherence, as was the case during the last five years in many Member States, constitutes a major macroeconomic obstacle to growth because it overburdens monetary policy and obliges the pursuit of the stability objective by means of high interest rates. In the short run, in order to ignite a sustainable recovery process it is of particular importance to improve the conditions for further falls in, and maintaining low, interest rates. This essentially demands that current and expected pay and budgetary trends be kept in line with the price stability objective. The sooner this is realized, the sooner interest rates can be further reduced substantially on a sound basis.

Resolute actions to raise permanently the Community's potential rate of growth and to restore its competitive position, both on its domestic and foreign markets. In effect, the second macroeconomic obstacle to growth resides in the Community's weak growth potential. To maintain a high rate of economic growth during the second half of the 1990s and to avoid a replication of the 1988-90 overheating, a significant rise in the investment ratio in the Community is needed. To increase the investment ratio by several percentage points, improved confidence, structural policies and wage developments, which secure further increases in investment profitability, will be essential. Moreover, such a wage moderation will help to improve the competitiveness of the EC economy. On the other hand, the recovery in investment has to be accompanied by an increase in the rate of national saving, particularly through a reduction in public dissaving. This means that budgetary consolidation efforts are not only needed for achieving public debt sustainability as intended by the Maastricht criteria but also for fostering the growth process by first avoiding the absorption of private savings by government current spending and then by bringing about a positive public sector contribution to increased national savings.

Specific measures to create more employment. A wide range of actions must be undertaken in this field and Member States should draw on suggestions from the Commission's White Paper. The most important ones are measures to reduce the barriers to employing people, active labour market policies and structural changes in the functioning of the labour market.

7. Respect of these policy guidelines will not only allow the Community to achieve higher and more employment-creating growth, it is at the same time a prerequisite for a significant improvement in economic convergence among Member States. Unfortunately, progress towards greater economic and monetary convergence suffered a setback during Stage I of EMU. This is clearly evidenced in the report on 'Progress with regard to economic and monetary convergence and with the implementation of Community law concerning the internal market', which the Commission presented to the Council in accordance with Article 109e of the European Community Treaty.

A considerable number of Member States have achieved a low rate of inflation consistent with the criterion defined in the Treaty. Visible progress is underway in some other countries. The task ahead is to lock in low inflation in those countries where it has already been achieved and to reinforce the move towards price stability in the other countries. Thanks to favourable inflation developments and the high level of financial integration achieved in the Community, long-term interest rates, in general, converged on a downward trend. These achievements contrast with the significant deterioration in public finances and the period of marked instability of exchange rates, culminating in the significant widening of the ERM fluctuation margins. The long and deep economic downturn was partly responsible for these developments but policy failures also contributed importantly. Therefore, implementation of economic policies along the lines recommended by the guidelines will also be conducive to bringing about a satisfactory degree of economic convergence over the medium term, so that the timetable for EMU remains realistic.

In line with the Treaty provisions, the Commission takes the view that real convergence must also be a major objective whose achievement will be the result of long-lasting efforts in the context of good and sound growth performances. The Commission acknowledges that supply conditions have improved considerably. Unfortunately, progress made in this area has been obscured by the recession and the sharp deterioration in labour market situations in the Community. Supply conditions improved primarily thanks to the implementation of the internal market; 95% of the White Paper legislation has now been adopted. This accomplishment is impressive, all the more so as important adjustments at Member State level were necessary. The economic effects of the internal market, although difficult to quantify, have been important. Yet, it is expected that from now on the real advantages of the internal market will grow in importance. A counterpart of the rapidly integrating Community economy is that Member States have increasingly been engaged in a process aimed at reinforcing the endogenous factors of growth. This is an intended and thus welcome consequence. However, in order to bear their full fruit, efforts to improve supply-side conditions, and in particular to bring about greater labour market flexibility, must be accompanied by sound macroeconomic policies and a satisfactory growth performance. Consequently, it is indisputable that in this area also, action compatible with the guidelines will at the same time revitalize the economic growth potential of the Community economy and ensure further progress towards real convergence.

8. Because of both their intrinsic value and importance for the recovery and integration process of the European Union, it was judged worthwhile giving a further dissemination to the broad guidelines and the convergence report by publishing them in *European Economy*. The structure of the volume is as follows:

The first part comprises documents related to the broad guidelines for the economic policies of the Member States and of the Community.

The first two chapters contain respectively the recommendations adopted by the Council and the Commission. The reader will see that there is a close identity of views between the Council and the Commission. Nevertheless, he will also observe some important differences. They essentially relate to the decision of the Council to insert in its recommendation the main tasks in the area of structural policies as worked out in the Commission's White Paper.

The structural pillar of the economic policy strategy was also dealt with in the framework document which the Commission approved on 10 November 1993 and served as the basis for the initial discussions between the Commission and the Member States on the content of the guidelines. This framework document is presented in Chapter III of Part A.

Although the present short-term economic outlook for the EC economy remains bleak, there is nothing inevitable in this state of affairs. This is shown in the technical annex presented in Chapter V of Part A which presents some medium-term scenarios simulated by the Commission services' QUEST model. This paper, drafted under the sole responsibility of the Commission services, illustrates that if Member States quickly implement the strategy recommended and adhere to it with determination during the next seven years, the Community would be able to reconcile a high growth and employment pattern with low inflation and significantly improved nominal and real convergence. Conversely, the simulation results also suggest that a continuation of the present unbalanced policy-mix and no convergence, risks pushing the Community into a low growth and employment trap, with deeply divergent economic performances and a worrisome social situation.

The second part of the volume presents the convergence report. I should stress that it concerns a Commission document and that Chapter I on economic and monetary convergence and Chapter II on the assessment of the internal market were prepared by the Directorate-General for Economic and Financial Affairs and by the Directorate-General for the Internal Market and Financial Services, respectively.

Henning Christophersen
Vice-President

Brussels, 11 January 1994

Part A

Broad economic policy guidelines of the Member States and of the Community drawn up in conformity with Article 103(2) of the Treaty establishing the European Community

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I — Council recommendation of 22 December 1993 on the broad guidelines of the economic policies of the Member States and of the Community

The Council of the European Union,

Having regard to the Treaty establishing the European Community, and in particular Article 103(2) thereof,

Having regard to the Recommendation from the Commission,

Having regard to the conclusions of the European Council of 10 and 11 December 1993,

Hereby recommends:

Article 103 of the Treaty establishing the European Community provides the framework for economic policy coordination from the start of Stage II of the process towards economic and monetary union. The economic policy guidelines adopted under that Article will constitute the reference for the conduct of the economic policies in the Community and in the Member States.

1. Main objectives

There are signs that the recession is bottoming out in the European Union. Output indicators and business surveys in a number of countries are showing signs of improved confidence and prospects. Long-term interest rates have declined substantially and most European central banks have lowered their leading rates. However, unemployment continues to increase in most Member States. Against this background, the broad guidelines for economic policies in 1994 should aim, as a priority, for the return of a sustainable and non-inflationary economic growth.

The Community should set itself the objective of, in the short term, reversing the trend and then, before the end of the century, significantly reducing the number of unemployed, at present standing at the unacceptable level of 17 million. A decrease in unemployment is imperative to reduce the negative economic and social consequences arising from this wastage of human resources. Higher employment creation is also necessary to achieve a more active society where all those wishing to join in the production process are given a chance to do so and where the weight of the factors leading to social exclusion is substantially reduced.

This employment objective should be obtained by a non-inflationary, strong and employment-creating growth, lasting over many years and respecting the environment. Higher growth is essential not only in relation to employment creation but also to enable the Community to reap the benefits of the internal market, to improve its economic and social cohesion and to meet its growing commitments in relation to the rest of the world. Since growth cannot be artificially generated, it must be brought about essentially by the effect of market forces and by the dynamism of the internal market, open to the outside world. The conclusion of the GATT negotiations on a global, durable and balanced basis and the Community's openness to new markets has a vital role to play in this respect.

Achieving a higher growth rate also requires a strengthening of economic convergence among Member States. Convergence will set in place the conditions for stronger job-creation and will allow the Community to reap the full benefits of the internal market. It will also make possible a successful transition to EMU.

In this respect the task of economic policy-makers is to allow market forces to display their full potential by:

(i) providing a stable and coherent macroeconomic framework;

(ii) removing the macro- and microeconomic obstacles to growth.

In the present situation the challenge is a dual one. Firstly, to act decisively to improve the conditions for growth consistent with the commitment to the creation of high employment in the medium term. Secondly, to create the economic and social conditions which will permit stronger, sustainable and more employment-creating growth in the medium to longer term.

The recovery process will require a restoration of confidence through a rebalancing of the current macroeconomic policy mix combined with credible structural measures. The sooner current and expected pay and budgetary trends incorporate the price stability objective, the sooner interest rates can be further reduced substantially on a sound basis. For lower interest rates, achieved on this basis, represent an important element to boost short-term prospects in the Community. Given the severity of the present situation, however, and the size of the budgetary adjustment to be undertaken in many countries, the recovery process may well be modest and hesitant. Therefore, the full realization of the initiatives agreed at the European Council meetings in Edinburgh and Copenhagen is of paramount importance.

In the medium term, policies and behaviour must remain consistent with stability. They must help to overcome rigidities and to put an end to the damaging reduction of national saving resulting from high budget deficits, thereby strengthening the investment conditions and the growth potential of the Community so that many years of stronger and more employment-creating growth become possible.

2. Economic policy guidelines

In order to create the conditions to realize the Community's economic objectives, in particular the increase of employment and the reduction in unemployment, the Council adopts the following broad economic policy guidelines:

2.1. Price and exchange-rate stability

The Community will aim to keep a stable macroeconomic framework. A rate of inflation of no more than 2 to 3% should be reached in most Member States by 1996 as a step towards price stability in the Community.

All policies and behaviours should be consistent with this objective. Those Member States who have already reached this level of inflation should ensure that policy measures are consistent with the maintenance of this performance. For the other Member States, determined action is needed to provide the basis for lower short-term and long-term interest rates, for example involving action related to budgetary consolidation, wage evolution and inflationary price developments in the services sector.

If these measures are implemented with sufficient speed, conditions would be established for both nominal and real interest rates to come down as inflation expectations are reduced. The setting-up of the EMI will represent an additional factor of stability and cooperation, given the important role it will play in strengthening arrangements for the coordination of Member States' monetary policies and in monitoring the functioning of the European Monetary System.

The high degree of integration and the reaping of the benefits of the internal market demand that the Community continues to aim for exchange-rate stability built on common efforts to make progress on convergence and to create sound economic fundamentals in all Member States of the Community.

The Community reaffirms its commitment to the EMU process and timetable as agreed in the Treaty on European Union. To this end it will intensify its efforts at achieving economic convergence.

2.2. Sound public finances

The restoration of confidence requires that in 1994 Member States prevent any further deterioration in their budgetary situations and carry forward the process of deficit reduction. In those Member States facing more worrying fiscal positions, confidence will benefit from an immediate strong pursuit of the consolidation process. This holds true especially for Member States with very high and rising public debt ratios. The consolidation process should intensify in those Member States with high budget deficits and which are expected to face a relatively favourable economic situation in 1994. In other Member States tight control of budgets will be necessary in 1994 but the emphasis should mainly be on credible medium-term consolidation strategies with measures to be already announced now which will take effect in future years as the recovery strengthens. At the Community level, the limits on EC spending and revenue agreed at the Edinburgh Council must be respected.

In 1995, Member States should continue action to make their public finance positions sustainable again. Under the expected growth path for the years ahead, this means action towards reducing budget deficits to the reference value indicated in the Treaty on European Union (3% of GDP). Most Member States have the potential to reach this goal by 1996, with the others needing more time. This action will contribute to meeting the criterion relating to public debt provided for in the Treaty.

The measures used to stabilize public budgets will give priority to reductions in current expenditure and to improving the efficiency of the tax system, for example, by strengthening action against tax evasion. All Member States need to reorient public expenditure to more productive uses and to increased investment in particular.

In the long term, Member States' budgetary policies will be directed towards contributing to higher national savings and investment. This will entail much lower budget deficits (perhaps close to balance by 2000).

2.3. Creating more employment

Member States and the Community will take resolute action to improve the functioning of their economies, aiming specifically at improving competitiveness and the Community's capacity to create jobs.

Because of the institutional, legislative and contractual peculiarities of each Member State, the Community's action must focus on defining objectives, while leaving Member States free to choose the means appropriate to their situation within a general framework defined in common. With this in mind, the Council considers that, in order to strengthen the capacity of the European economy to create jobs, Member States should draw on suggestions from the Commission White Paper.

2.4. Pay, investment and employment

Member States set themselves the objective of a significant increase in the share of investment in GDP. Meeting this objective is essential in order to increase the Community's potential for sustainable non-inflationary growth of the European economy in the medium and long term. Moreover, the recovery in private investment will, in the short term, help to stimulate demand.

Recovery in investment will be possible if society is prepared today to make the efforts which will bring more prosperity and more jobs tomorrow. That calls, amongst other things, for pay developments consistent with the improvement in the profitability of investment and in the competitiveness of European undertakings on world markets. That process will also contribute to promoting job-creation in the immediate term.

In the short term, the need to create new jobs will not permit real pay growth in most countries and may result in real pay reductions in certain sectors of the economy. However, pay movements should provide for an appropriate differentiation according to the situation in Member States, industrial sectors and firms, as well as vocational qualifications and work experience.

To this end, governments and the social partners will use all instruments which national procedures provide to ensure that pay trends in their countries adapt rapidly to the objective concerning inflation.

Pay moderation in the public sector is also important, on the one hand to take the pressure off public finance and to accelerate promotion of public investment and on the other to set an example for the private sector.

Schemes promoting new forms of labour organization on a sound economic basis may be introduced through negotiation in a decentralized way (at sector or enterprise level).

2.5. Reducing the indirect cost of labour

Where appropriate, Member States must intensify their efforts to bring about a significant reduction in the indirect cost of labour. Such reduction would enable a better balance to be achieved between the costs of the various production factors. Failing that, the labour factor, in particular low-skill labour, would suffer excessively.

Action to be undertaken in this field has a twofold objective:

(i) it should promote job-creation in services responding to new society needs, the development of which is currently discouraged by the high level of the indirect cost of labour;

(ii) combined with pay moderation, it should also save jobs in the sector exposed to international competition by curbing the replacement of labour by capital and the relocation of activity.

In order to encourage the process in the right direction, Member States are invited to examine to what extent an adaptation of the financing mechanisms of their social protection system, along with saving measures, could further contribute to the promotion of employment. However, changes in the systems should not increase Member States' indebtedness. The question will be re-examined at Community level on the basis of reports which Member States are invited to present. Fiscal measures possibly relating, *inter alia,* to the environment could be one of the means of offsetting a drop in social contributions, within a general context of stabilizing all statutory contributions and reducing the tax burden.

2.6. Active policies towards employment

Meeting the objective will also depend on adjusting employment policies to the changing economic environment.

Member States are invited to:

(i) improve educational and job-training systems so that those who enter the labour market have the possibility of developing professionally and at the same time have skills that are useful to undertakings;

(ii) help reintegrate the long-term unemployed in the labour market;

(iii) improve the functioning of local placement services;

(iv) remove excessive rigidities which prevent the labour market from functioning effectively;

(v) improve labour mobility;

(vi) promote liberalization measures aimed at sheltered sectors, including, where appropriate, the services industry.

2.7. Completing the internal market

The existence of a large export-oriented internal market is a major asset of the European economy, and it must be fully exploited. The full incorporation of Community legislation into national law, simplification and reduction of the legislation, the creation of a fiscal, administrative and financial environment favourable to small and medium-sized enterprises, the application of the competition rules and the control of State aids are essential elements in the completion of the internal market.

Likewise, the capital market must be made more efficient in order to encourage a flow of savings into productive job-creating investments.

The trans-European networks are also an essential element for the effective operation of the internal market and the reinforcement of economic competitiveness. The Council will make full and rapid use of the new possibilities offered by the Treaty (Article 129b).

*

The economic policy guidelines laid out above will constitute the reference for all future multilateral surveillance exercises. The implementation of the guidelines will be monitored in accordance with the procedures laid down in the Treaty. The Council will also assess the implementation of those guidelines in their assessment of Member States' convergence programmes.

Box: Articles 102a and 103 of the Treaty establishing the European Community: relevant provisions on economic policy and broad guidelines

Article 102a

Member States shall conduct their economic policies with a view to contributing to the achievement of the objectives of the Community, as defined in Article 2, and in the context of the broad guidelines referred to in Article 103(2). The Member States and the Community shall act in accordance with the principle of an open market economy with free competition, favouring an efficient allocation of resources, and in compliance with the principles set out in Article 3a.

Article 103

1. Member States shall regard their economic policies as a matter of common concern and shall coordinate them within the Council, in accordance with the provisions of Article 102a.

2. The Council shall, acting by a qualified majority on a recommendation from the Commission, formulate a draft for the broad guidelines of the economic policies of the Member States and of the Community, and shall report its findings to the European Council.

The European Council shall, acting on the basis of the report from the Council, discuss a conclusion on the broad guidelines of the economic policies of the Member States and of the Community.

On the basis of this conclusion, the Council shall, acting by a qualified majority, adopt a recommendation setting out these broad guidelines. The Council shall inform the European Parliament of its recommendation.

3. In order to ensure closer coordination of economic policies and sustained convergence of the economic performances of the Member States, the Council shall, on the basis of reports submitted by the Commission, monitor economic developments in each of the Member States and in the Community as well as the consistency of economic policies with the broad guidelines referred to in paragraph 2, and regularly carry out an overall assessment.

For the purpose of this multilateral surveillance, Member States shall forward information to the Commission about important measures taken by them in the field of their economic policy and such other information as they deem necessary.

4. Where it is established, under the procedure referred to in paragraph 3, that the economic policies of a Member State are not consistent with the broad guidelines referred to in paragraph 2 or that they risk jeopardizing the proper functioning of economic and monetary union, the Council may, acting by a qualified majority on a recommendation from the Commission, make the necessary recommendations to the Member State concerned. The Council may, acting by a qualified majority on a proposal from the Commission, decide to make its recommendations public.

The President of the Council and the Commission shall report to the European Parliament on the results of multilateral surveillance. The President of the Council may be invited to appear before the competent Committee of the European Parliament if the Council has made its recommendations public.

5. The Council, acting in accordance with the procedure referred to in Article 189c, may adopt detailed rules for the multilateral surveillance procedure referred to in paragraphs 3 and 4 of this Article.

II — Commission recommendation of 24 November 1993 on the broad guidelines of the economic policies of the Member States and of the Community: 'Restoring growth and employment — strengthening convergence'

Article 103 of the Treaty on European Union provides the framework for economic policy coordination from the start of Stage II of the process towards economic and monetary union. The economic policy guidelines adopted under this Article will constitute the reference for the conduct of the economic policies in the Community and in the Member States.

1. Main objectives

The Community should aim to substantially increase employment creation so as to cut significantly the present high unemployment levels. A decrease in unemployment is imperative to reduce the negative economic and social consequences arising from this wastage of human resources. Higher employment creation is also necessary to achieve a more active society where all those wishing to join in the production process are given a chance to do so and where the weight of the factors leading to social exclusion is substantially reduced. Reducing unemployment, for instance cutting it by half by 2000, would imply the creation of at least 15 million new jobs.

This employment objective should be obtained by a non-inflationary, strong and employment-creating growth, lasting over many years and respecting the environment. Higher growth is essential not only in relation to employment creation but also to enable the Community to reap the benefits of the internal market, to improve its economic and social cohesion and to meet its growing commitments in relation to the rest of the world. But growth cannot be artificially generated, it must be brought about mainly by market forces and by the dynamism of the European internal market, open to the outside world.

Achieving higher sustainable growth also requires a strengthening of economic convergence among Member States. Convergence will set in place the conditions for stronger job creation and will allow the Community to reap the full benefits of the internal market. It will also make possible a successful transition to EMU.

In this respect the task of policy-makers is to allow market forces to display their full potential by:

(i) providing a stable and coherent macroeconomic framework;

(ii) removing the macro- and microeconomic obstacles to growth.

In the present situation the challenge is a dual one. Firstly, to act decisively to support growth in the short term without putting at risk the commitment to high employment creation in the medium term. Secondly, to create the conditions which will permit a stronger, durable and more employment-intensive growth in the medium to longer term.

Igniting the recovery process will require a restoration of confidence through a rebalancing of the current macroeconomic policy mix combined with credible structural measures. Lower interest rates, achieved on a sound basis, represent the most potent instrument presently available to boost short-term prospects in the Community. The sooner current and expected pay and budgetary trends incorporate the stability objective, the sooner interest rates can be further reduced substantially on a sound basis. Given the severity of the present situation, however, and the size of the budgetary adjustment to be undertaken in many countries, the recovery process may well be modest and hesitant. In these circumstances it may be necessary to envisage an intensification of the Community initiatives agreed at the European Council meetings in Edinburgh and Copenhagen.

In the medium term, policies and behaviour must remain consistent with stability. They must help to overcome rigidities and to put an end to the damaging reduction of national saving inflicted by high budget deficits, thereby strengthening the investment conditions and the growth potential of the Community so that many years of stronger and more employment-creating growth become possible.

2. Policy guidelines

In order to create the conditions to realize the Community's employment/unemployment objectives, the Commission recommends to the Council to adopt the following broad economic policy guidelines.

2.1. Price and exchange-rate stability

The Community will aim to keep a stable macroeconomic framework. A rate of inflation of no more than 2 to 3% should be reached for the Community average by 1996.

Achieving this target implies that all policies and behaviours should be consistent with this stability objective. Those Member States who have already reached this target range should ensure that policy measures are consistent with the maintenance of this performance. For the other Member States, more courageous initiatives are needed involving determined action in relation to budgetary consolidation and wage evolution in order to allow a loosening of monetary policy on a sound basis.

If these measures are implemented with sufficient speed, short-term interest rates could come down rapidly and long-term rates would follow as inflationary expectations are stabilized.

The high degree of integration and the reaping of the benefits of the single market demand that the Community continues to aim for exchange-rate stability built on sound economic fundamentals embracing both nominal and real variables.

The Community reaffirms its commitment to the EMU process and timetable as agreed in the Treaty on European Union. To this end it will intensify its efforts at achieving economic convergence.

2.2. Sound public finances

The restoration of confidence requires that in 1994 Member States prevent any further deterioration in their budgetary situations and aim to start the process of deficit reduction. In those Member States facing more worrying fiscal positions, confidence will benefit from an immediate strong pursuit of the consolidation process. This holds especially for Member States with very high and rising public debt ratios. The consolidation process should also start in those Member States expected to face a relatively favourable economic situation in 1994. In other Member States tight control of budgets will be necessary in 1994 but the emphasis should mainly be on credible medium-term consolidation strategies with measures to be already announced now which will take effect in future years as the recovery strengthens.

From 1995, the Community will aim at making its public debt position sustainable again. Under the expected growth path for the years ahead, this means reducing budget deficits to the reference value indicated in the Treaty on European Union (3% of GDP). The Community could achieve this goal by 1996/97. Most Member States have the potential to reach this goal by 1996, with the others needing more time.

The measures used to consolidate public budgets will give priority to reductions in current expenditure and to improving the efficiency of the tax system. All Member States need to reorient public expenditure to more productive uses and to increased investment in particular. In addition, it is necessary to adapt the tax system in a way which will contribute more to employment creation. Reductions in employers' social security contributions in a number of Member States, especially for the lowest paid and for younger workers, are particularly important in this regard although any action taken will clearly need to be revenue-neutral given the scale of the budgetary adjustment to be achieved in many countries.

In the long term, Member States budgetary policies will be directed towards contributing to higher national savings and investment. This will entail much lower budget deficits (perhaps close to balance by 2000).

2.3. Creating more employment

Member States and the Community will take determined action to improve the functioning of their economies, aiming specifically at improving competitiveness and the Community's underlying capacity to create jobs. Such structural measures will be highlighted in the forthcoming White Paper on 'Growth, competitiveness and employment'.

In addition to the microeconomic measures to be presented in the White Paper the overall evolution of wages and salaries will play a crucial role in creating jobs. To this end, governments and the two sides of industry will use all the instruments that national arrangements put at their disposal to ensure that wage developments in the Community adapt rapidly to the agreed inflation objective.

In the short term, the need to create new jobs will not allow for real wage increases in most countries. Once the recovery sets in and real wages will be able to increase again, wage developments will allow an increase in investment profitability by keeping real wage increases below productivity growth. For example, between 1982 and 1989 real wages per head increased by about 1 percentage point less per year than productivity growth. Furthermore, the wage evolution will provide for an appropriate differentiation according to member countries, regions, vocational qualifications and work experience.

*

The policy guidelines laid out above will form the central core of all future multilateral surveillance exercises. The broad framework for, and assessment of, Member States convergence programmes will be established by the guidelines. By laying out a credible and coherent implementation programme for the broad policy orientations, individual convergence programmes will act as symbols of the degree of political commitment which individual Member States attach to the Community's overall policy objectives for 2000.

III — Framework for the broad economic policy guidelines: 'Restoring growth and employment — strengthening convergence' [1]

The ratification of the Treaty on European Union provides the basis for a substantial strengthening of the coordination process in the Community with the entry into force, under Article 103(2), of the provisions relating to the broad guidelines for the economic policies of the Member States and of the Community. All future surveillance exercises will take place in the policy framework provided by these agreed guidelines, with the latter being used as the basis for the monitoring and evaluation of Member States economic policies and thus ensuring greater transparency and consistency in policy-making in the Community.

1. Overall objectives

Unemployment represents the single most important problem facing Community policy-makers. After a period of decline in the second half of the 1980s, the number of people out of work is rising again and could reach a level between 11 and 12% of the active population in 1994. Furthermore, on present trends, the medium-term perspective offers little comfort with unemployment rates remaining at more than 10% in 1996/97. This is why it is essential to focus policies on stopping this upward trend and reducing unemployment substantially. The Commission therefore recommends that the Community set itself the objective of creating at least 15 million new jobs, thereby halving the current rate of unemployment by the turn of the century.

The negative economic and political consequences of an entrenched unemployment problem need little elaboration. The dismal short-term economic situation and outlook combined with the projected medium-term failure to significantly reduce an already alarming unemployment total highlight clearly the magnitude of the policy task presently facing the Community. The challenge is a dual one:

(i) to act decisively to support growth in the short term without putting at risk the commitment to high employment creation in the medium term.

(ii) to create the conditions which will permit a stronger, durable and more employment-intensive growth in the medium to longer term.

Meeting these challenges will allow the Community to get back to the convergence path needed to achieve EMU.

1.1. Igniting the recovery process

Confidence factors will play a critical role in any recovery process. Authorities can contribute to a restoration of confidence through a rebalancing of the current policy mix combined with credible structural measures, including a successful completion of the Uruguay Round and efforts to ensure the correct functioning of the internal market, which will lay the ground for a sustained recovery.

An important contribution macroeconomic policy can make to the prospects for recovery at the present time is through a rapid reduction in interest rates. Interest rates have already come down significantly over the past 12 months. However, given the depth of the present recession they still remain too high in many countries, especially at the short-term end. Under these circumstances, the first requirement is to create the conditions for further substantial reductions in short-term interest rates. This calls essentially for expected budgetary and pay developments to be kept in line with the monetary authorities' stability objective. Any lowering of short-term rates not warranted by appropriate budgetary and pay behaviour would risk being offset by expectations of higher future inflation and higher long-term rates. On the other hand, if credible plans for budgetary consolidation and agreements leading to moderate pay increases were to materialize, expectations would be favourably influenced and central banks might be able to lower short-term interest rates in advance of actual developments.

Lower short-term interest rates throughout the Community would reduce tensions within the ERM, would improve the financial position of firms and would ease the debt service burden of public budgets. The scope for reductions is large: interest rates could come down substantially in Germany when appropriate policies are implemented while in other countries the reductions could be even larger to the extent that interest rate differentials can be reduced. A further significant reduction, say two to three points in the Community average, would signal to economic agents that the worst is over, that monetary policy had been loosened as much as it was possible and that nothing would be gained by further postponing any investment decision which may have been contingent on the availability of the best financing conditions.

A lowering of short-term rates in the Community, all other things being equal, would have as a consequence a lowering of Community currencies *vis-à-vis* those third countries with a positive impact on the competitiveness of European enterprises. Together with the restoration of confidence, this would trigger an export/investment-led cyclical upswing in the Community which would set the economy along the desired medium-term path. However, to the extent that Community currencies actually declined *vis-à-vis* third currencies, there would be an increase in inflationary pressures resulting from import prices which should not be passed

[1] This document was adopted by the Commission on 10 November 1993.

through to wages and would require an even stronger containment of other costs.

1.2. Tackling unemployment

However, even if recovery takes hold faster than is presently anticipated, unemployment will still remain very high for many years to come unless appropriate policies are adopted and assiduously implemented. The ambitious target the Community intends to set itself implies that very high rates of employment creation (1,5 to 2% a year) be achieved and maintained over many years.

This calls for policies which aim at creating the conditions for a substantial increase in both the rate of economic growth and its employment content. At present these crucial variables are very disappointing. The rate of growth which the Community economy at present can maintain over many years without experiencing overheating problems, the potential rate of growth, is estimated to be only marginally higher than 2%. The current employment content of growth is also not very high with rates of growth of more than 2% needed to produce increases in employment.

Implementing these policies to the extent needed will not be easy. However, if this is done along the lines indicated in the present guidelines and the effort is sustained over many years, it could be realistically envisaged that the Community's economy returns by 1995/96 to a growth path of at least 3% while the employment intensity of growth could increase progressively depending on the extent to which appropriate policies are adopted.

A strong, employment-creating rate of growth cannot be artificially generated, it must be brought about mainly by market forces and by the proper functioning and dynamism of the European single market, open to the outside world. The task of policy-makers in this respect is to allow market forces to deploy their full potential by:

(i) providing a stable and coherent macroeconomic framework;

(ii) removing the macro- and microeconomic obstacles to growth.

The first of the macroeconomic obstacles is that represented by the current lack of coherence between the stability objective of monetary authorities and budgetary and pay developments. The sooner pay and budgetary trends incorporate the stability objective, the sooner interest rates will be reduced on a sound basis.

A second macroeconomic obstacle resides in the Community's weak potential rate of growth. Permanently raising the Community's underlying rate of growth will require the provision of an appropriate stability-oriented macroeconomic framework and increasing the dynamism and efficiency of the economies by removing the many structural Eimpediments to growth, to competitiveness and to a higher employment content of growth which currently exist. A credible overall macro- and microeconomic framework will underpin a recovery in growth prospects through boosting the confidence of investors and consumers.

However, for the recovery to be sustainable, the rate of investment must be increased by several percentage points. In this regard it is important to complement confidence-enhancing measures by actions:

(i) to substantially strengthen investment profitability and the competitiveness of firms; and

(ii) to progressively increase national savings, in particular by a reduction in public deficits.

The market forces which must produce this higher growth rate are often hindered by many structural rigidities which prevent growth from becoming more employment-creating. This is why it is necessary to pursue structural policies in a concrete and targeted way.

2. Guidelines for growth and employment creation: analytical explanations

The quest for stronger employment creation requires an appropriate strategy for both macro- and microeconomic policy. The Community needs an explicit exposition of the broad guidelines to be followed in the key areas of monetary policy, budgetary policy, labour market policy and structural adjustment in order to provide the framework in which a committed and concerted strategy for growth, competitiveness and employment can be implemented. The following paragraphs provide the essential background details on which the detailed policy prescriptions given in the recommendation are based.

2.1. Price and exchange-rate stability

Inflationary trends: Although the stability target of monetary policy is not usually spelt out explicitly, it can be assumed to imply a rate of inflation not higher than 2 to 3%. The

Community as a whole has clearly not yet achieved this latter stability objective although good progress has been made in recent years. Further small progress is forecast to occur next year. The easing in inflationary pressures since 1991 undoubtedly reflects the combined impact of the worsening economic downturn and the relatively tight monetary policy stance which were hallmarks of the period as a whole, but important structural changes in a number of countries have also contributed. With regard to 1994, the small improvement which is forecast reflects the impact of a number of counterbalancing forces.

The figures for the Community as a whole hide a wide range of performances at the individual Member State level. In 1993, five countries, Belgium, Denmark, France, Ireland and the Netherlands are forecast to register inflation rates which are either lower than, or fall within, the 2 to 3% range. Of the remaining seven Member States, five — namely Germany, Spain, Italy, Luxembourg and the United Kingdom — are forecast to have inflation rates ranging from 3½ to 5% with Portugal and Greece expected to register rates of the order of 7 and 14% respectively. Most of the latter seven countries are, however, forecast to show some improvement in 1994.

Exchange-rate stability: Monetary cooperation is facing its greatest challenge since the inception of the EMS in 1979. Continued speculative attacks on the ERM grid led to a temporary widening of the systems fluctuation margins to plus or minus 15% on 2 August 1993. However, despite the increased potential for Member States to differentiate their monetary stance, there has been no dramatic reductions in interest rates over the intervening months. This suggests that many Member States have not abandoned their commitment to monetary cooperation based on stable exchange rates. They have clearly weighed up the advantages of this increased monetary room for manoeuvre against the potential dangers associated with the loss of counter-inflationary credibility, the breakdown of monetary policy coordination and excessive exchange-rate volatility.

Policy coordination will need to be strengthened to avoid destabilizing financial flows and speculative attacks. The central bank's autonomy should be significantly extended in a number of Member States as soon as possible and, in any case, within the deadline set out in the Treaty on European Union. Monetary coordination will also need to be deepened. The EMI must play an important role in this respect. Re-establishing the credibility of the monetary integration process demands that Member States must reaffirm their commitment to the convergence criteria and to the existing EMU timetable.

2.2. Sounder public finances

The severity of the public finance situation which is presently facing the Community owes much to an insufficient consolidation of budgets during the second half of the 1980s when macroeconomic conditions in a number of countries were clearly favourable to a much larger adjustment of budgetary imbalances. Net borrowing steadily worsened from 2,7% of GDP in 1989 to a forecast 6,4% this year, thus substantially overshooting the previous peak of 5,2% of GDP reached in 1982. This deterioration has had the effect of raising the Community's debt/GDP ratio by almost 10 percentage points from 59,5% of GDP in 1989 to a forecast 68,9% in 1993. Rising debt levels inevitably mean growing interest payment burdens on national budgets. In the Community as a whole, this latter type of expenditure already represents about 11% of total public expenditure and 5½% of GDP (which is almost as high as the existing budget deficits), while in the countries with the most worrying situations, the corresponding figures are almost double the Community average. Budgetary consolidation is essential to ensure that interest payments on the public debt do not continue to increase their share of overall government expenditure, thereby leading both to sustainability worries and to the crowding-out of more productive forms of spending.

All 12 Member States are forecast to witness a deterioration in their borrowing positions in 1993 with significant budgetary slippage of the order of 1½ percentage points of GDP or more expected in seven countries, namely: Denmark, Germany, Greece, Spain, France, Portugal and the United Kingdom. The authorities in the latter Member States could not ignore the seriousness of the economic downturn which had emerged and as a result allowed the 'automatic stabilizers' to operate to a greater or lesser extent. Some of the countries have gone further and have introduced a measure of discretionary demand support into their stance. In addition, all countries, in the context of the Edinburgh growth initiative, are committed to reviewing their spending programmes with the aim of switching expenditure towards those items with the potential to generate the greatest impact on growth and employment.

In the short term, up to the end of 1994, given the state of public finances in most Member States there is widespread agreement that any margin which had previously existed for a discretionary loosening of budgetary policy has been exhausted and there is now an urgent need for consolidation. The policy options still available concern only the timing and the pace of the necessary consolidation. Timing and pace depend very much on the degree of seriousness of the budgetary problem in each country and on the point in the cycle where Member States currently find themselves. In some countries, the gravity of the economic situation would appear to preclude immediate implementation of consolidation measures. In these cases, it is necessary to credibly pre-announce measures to be taken when conditions improve in order to convince economic agents that consolidation will at least go in parallel with the return to stronger growth. This is essential for confidence and credibility. In other countries, the risks are so large that consolidation efforts have to be undertaken already, notwithstanding the depressed economic conditions pertaining.

In the medium term, the policy objective must be to exploit the recovery to make public debt positions sustainable again. This in essence means respecting the Maastricht criteria in terms of budget deficits (3% of GDP).

In the longer term, the objective will be to contribute to the increase in national savings deemed necessary to finance higher investment levels which implies even lower budget deficits.

2.3. Higher employment creation

In the present difficult economic circumstances solidarity is needed in order to extricate ourselves from the current downturn and to distribute the burden of adjustment fairly among all groups in society. Pay developments which contribute to higher employment creation are one important way for workers to express solidarity with those who are less fortunate than themselves. Pay trends are still not ideal with the negative consequences of the slippage which occurred in 1990/91 still being experienced. In some countries, real wages are still increasing even though productivity increases are currently due only to labour shedding. Additional efforts must, therefore, be requested from employers and employees to ensure the establishment of wage trends more appropriate both to the achievement and maintenance of monetary stability and to the generation of higher rates of investment and employment creation. The social partners should work together to ensure that the achievement of the above objectives results in the maintenance of the existing social consensus.

Nominal compensation of employees per head in the Community as a whole grew at an annual average of nearly 7% over the period 1990-92, which was clearly inconsistent with the monetary authorities' stability objective. On a more encouraging note the 1993 forecast is for an increase of less than 4% in nominal wages per employee. This average increase for the Community is, however, made up of sharply contrasting performances for individual Member States. Six countries, namely Denmark, Germany, France, Italy, the Netherlands and the United Kingdom are forecast to show rates of increase which are lower than the Community average. Belgium, Ireland and Luxembourg are expected to witness increases in the range 4½ to 6%. Spain and Portugal are likely to be in the range 7 to 9% with Greece expected to experience a rate of increase which is close to three times the Community average.

Wage moderation has an important role to play in producing stable macroeconomic conditions and in boosting investment profitability, both of which are essential to the Community's medium-term efforts to generate higher growth and employment. In relation to stability, while, on the one hand, the weakening of economic activity is working to reduce inflationary pressures, on the other hand, pay increases, though moderating, continue to be inconsistent with the restoration of price stability in a large number of countries in the Community. An improvement in the profitability of investment is essential to efforts to substantially increase the investment ratio in the Community. The experience of the 1980s shows that the most effective way to increase investment profitability is to achieve pay trends where real wages will increase, but less than the increase in productivity. During most of this period (1982-89), real wages increased by 1 percentage point less than productivity growth. This can be regarded as an acceptable rule of thumb for medium-term real wage trends. This will achieve a twofold objective by increasing profitability while simultaneously allowing for an increase in consumption and overall demand.

But higher employment-creation requires also determined action to remove the rigidities, of differing nature, which at present hinder it and implementing active labour market policies aimed at improving the efficiency of labour markets and particularly to make wage-setting procedures more adaptable to macroeconomic conditions. This point has long been recognized and labour market flexibility measures or preoccupations figure in most of the Member States' convergence programmes but especially those for Belgium, Spain, Ireland, the Netherlands, Portugal and the United Kingdom. During the 1980s, progress in these areas has taken place, but the results have been insufficient. The seriousness of the present situation suggests that a fundamental change will have to take place if the Community is to achieve its employment and unemployment targets. Such a substantial change can only be achieved via partnership and participation and not by conflict and coercion.

With respect to an active labour market policy, a wide range of specific measures could be undertaken. The most important ones are:

(i) Reducing barriers to employing people. This includes changing the pattern and level of working time to reflect new work organization and job needs; adapting the incidence of taxation in ways which are beneficial to employment including reducing non-wage costs; improving the adaptability of the labour market by adjusting the regulatory framework; increasing flexibility in the use of labour in SMEs. Many of these changes have a particular relevance to improving the quality and quantity of women's participation in the labour market.

(ii) Improving the chances of disadvantaged groups. In particular, this covers: promoting and improving the efforts towards equal opportunities between women and men; maximizing the impact of Community structural policies in promoting employment and reducing unemployment; promoting local employment development and increasing the capacity of local areas to manage change; addressing youth employment problems; combating long-term unemployment and labour market exclusion.

(iii) Contributing to the long-term competitiveness of the Community economy through an improvement of its stock of human capital. This implies developing the human resources in ways that both raise their quality and value, and ensure that the Community's competitiveness is optimized by their most effective development and deployment, with particular regard to continuous training and skill upgrading, basic and introductory training and new technology skills.

(iv) Anticipating and accelerating the creation of new jobs, activities and enterprises particularly in labour intensive areas, in order to maintain the pace of structural change and adjustment in line with economic and social development and needs. This particularly concerns fully exploiting the potential of SMEs, and includes development of new jobs in sectors such as the environmental industries, the care sector, the arts and the cultural and tourism industries.

2.4. A more efficient productive system

There appears to be almost universal acceptance of the need to improve the underlying dynamism and efficiency of the Community's economy. Such consistent and repeated airing of these issues suggests that something is seriously amiss in this regard and that efforts in the structural arena are indispensable to policy-makers' efforts to ensure a sustainable recovery process.

Action is necessary to increase competition (completion and smooth functioning of the single market including the development of trans-European networks (TENs), successful and balanced conclusion of the Uruguay Round of trade negotiations); to remove unnecessary regulations; to promote non-physical investment and in particular increasing better quality research and development expenditure, including action to ensure the speedy application and dissemination of results; to reorient policy in favour of industrial competitiveness towards horizontal measures, such as quality promotion, and high-growth markets (including health, environment, biotechnologies, multimedia and culture) in order to better promote the creation of value-added and to improve the impact on employment; to promote industrial cooperation, both inside the Community and at the international level; to facilitate the development of competitive industrial clusters and networks throughout the Community.

However, structural reform, by its very nature and time-horizon, cannot be heavily relied upon in the short-term context. In certain cases, there could be some positive short-term effects when structural reforms are so strong as to signal a regime change but, by and large, the effects of such actions will be felt over the medium term. While the presently very depressed state of the Community's economy makes structural adjustment more difficult, as it increases resistance to change, it is important to remember that existing problems in this area result essentially from lack of action in the past. There is no justification for delaying the necessary adjustment any longer.

The nature and gravity of the structural problems facing Member States varies enormously from country to country. The convergence programmes indicate, at least for some countries, a number of structural measures required by the economy of the Member State concerned. Social security and tax reforms are important in the programmes of Belgium, Spain, Ireland and the Netherlands as a means of improving work incentives. Privatization and deregulation proposals form a significant part of the German, Spanish, Italian and Portuguese programmes. Action in relation to the strengthening of competition policy and to the reduction of State aids and subsidies feature in the programmes for Germany, Italy and the Netherlands. In relation to the remaining Member States, the French economy still suffers from some structural weaknesses, particularly in the area of the labour market. In Denmark and Spain, structural labour market problems have long been identified as a potential obstacle to higher growth. In the United Kingdom, action is still necessary to reduce subsidies and to enhance competition and market flexibility. Finally, in relation to Greece, radical reform is needed concerning the deregulation of goods, labour and services markets, as well as tax and social security reform.

3. A collective effort is needed

The guidelines, if acted upon, will serve as a blueprint both for the Community's short-term economic recovery process and for the setting-in-place of the conditions necessary to generate a much improved growth and employment performance over the medium to longer term. The Community's strategy, as laid out in the guidelines, is a combination of macroeconomic and structural elements which is specifically aimed at increasing job creation and thereby substantially reducing the unemployment rate before the end of the present century. It is necessary to adhere to the above strategy in order to bring about a significant acceleration in the Community's potential rate of growth and in order to make this growth more employment-creating.

Achievement of the latter objective will, however, require a concerted effort, stretching over many years, on behalf of all Member States and of the Community to adhere closely to the policy guidelines laid out in this document. If these policy prescriptions are assiduously followed by all the actors involved, the goals described in the previous paragraph are clearly within reach. As always, however, past experience indicates that the major stumbling block will undoubtedly be the political will and perseverance which is essential to ensure a successful implementation of the required policy adjustments. In this regard, Member States' convergence programmes have a crucial role to play in symbolizing the degree of political commitment which individual countries attach to what can only be described as an audacious growth and employment strategy for 2000. Convergence programmes must, therefore, in order to establish the resolve of national governments, lay out a credible and coherent implementation programme for the broad policy orientations set out under the various headings given earlier. The guidelines document must form the central core of all future multilateral surveillance exercises, acting both as a tool to guide the Member States in delineating the broad framework for their respective programmes and as an assessment instrument for establishing the compatibility of individual programmes with the Community's overall policy objectives.

IV — Annex: Joint opinion of the European Social Partners on the framework for the broad economic policy guidelines

The European Social Partners — the ETUC, UNICE and CEEP[1] — have individually made inputs to the Commission's White Paper on growth, competitiveness and employment. Additionally, the Social Partners have agreed to submit jointly the following points of relevance to the Community's economic policy guidelines — an exercise which is closely related to that of the White Paper.

1. The European Social Partners are deeply concerned by the very high and increasing levels of unemployment and by the deterioration in the economic performance generally which is not only due to the grave recession but also to more fundamental problems of competitiveness. In their Joint Opinion of 3 July 1992 the Social Partners demanded a cooperative growth strategy for more employment which up to now has not been fully implemented. The framework for the broad economic policy guidelines recommended by the Commission takes their proposals into account. The Social Partners broadly support these guidelines which aim at reducing unemployment to 5% by 2000, this to be obtained by durable, stronger and more employment-creating growth of about 3,5% p.a., respecting the environment. For the desired growth process to be durable, it has to be brought about by appropriate supply-side-oriented measures, by reviving economic dynamics in a stable and coherent macroeconomic framework, by removing the macroeconomic and structural obstacles to growth and by strengthening the competitiveness of European enterprises. In order to reach these objectives, a number of conditions in terms of economic policies and Social Partners' behaviour should be met. An effective coordination of economic and monetary policy at the Community level should be realized on the basis of these guidelines through the surveillance procedures established by the Treaty on European Union and especially those provisions concerning Stage II of economic and monetary union, thus helping the decision-making process and creating mutually reinforcing effects.

2. Rates of growth of the required order of magnitude have been achieved in the recent past — but they were not sustained. The Social Partners recognize that to strengthen the Community's medium to longer-term capacity in production and job creation, a significant increase in the resources going into investment is required. The Commission has calculated that the investment share of GDP has to increase progressively from less than 20% at present to about 23 to 24%. A substantial recovery of private investment is essential. This requires stability, profitability, a development of demand which is not purely consumption-led and a widespread understanding of the whole process. If matched in the medium term by higher savings, increasing investment would be consistent with internal and external balance. In the medium-term growth process, lower public deficits will contribute to a higher European savings ratio and the external balance should be underpinned by improved competitiveness. Such a development is needed in order to achieve the medium-term growth and employment objectives which in turn require that economic policies and collective agreements establish a coherent macroeconomic framework.

3. The European Social Partners agree that the implications for employment and collective bargaining of the guidelines should be discussed and taken into account by the Social Partners at all relevant levels of negotiations. As far as pay issues are concerned, the Social Partners have already expressed their consensus view in their joint opinion of 3 July 1992:

'The conduct of wage negotiations is under the responsibility of the Social Partners. The more credible and socially acceptable economic policies are, the easier the Social Partners can anticipate low or decreasing inflation rates in the results of their wage negotiations. This would reduce the strain on monetary policy and contribute to the reduction also of short-term interest rates. Furthermore, wage developments have to take into account the requirements of the profitability of employment-creating investment, the competitiveness of enterprises on the world markets and the implications of full economic and monetary union. The non-inflationary and sustainable growth process, thus generated, would provide the appropriate scope for real wage increases which underlines the interrelation between the European integration process and rising living standards.'

4. The European Social Partners recognize that policies are required not only to promote growth and to make growth more employment-creating and more environment-friendly, but also to correct and avoid macroeconomic imbalances and to continue vigilance in the fight against inflation. To achieve price stability, limiting inflation to a range of 2% to 3%, as recommended by the Commission to make the required growth sustainable, may appear ambitious but it has already been achieved by several member countries. The Social Partners' behaviour as described under (3) would help monetary policy to achieve the stability target without being unduly restrictive and would help fiscal policy to reach sound deficit and debt positions in the growth process. Such a policy mix, which will promote convergence of growth across Member States, is a precondition for intra-Community exchange-rate stability and for the desired transition to EMU.

1 ETUC: European Trade Union Confederation; UNICE: Union des Confédérations de l'Industrie et des Employeurs d'Europe; CEEP: Centre Européen de l'Entreprise Publique.

5. The strategy for growth and employment cannot just be a medium-term exercise. The growth process must be restarted now — and this requires a quick reduction of short-term interest rates achieved by sound economic policies. In practice, this means that central banks and markets have to be convinced that medium-term budgetary consolidation is credible and socially balanced. Progress in meeting the inflation objective and a sufficiently broad and reliable social consensus, reflected in collective agreements, would help central banks to accelerate their interest-rate reductions. Long-term interest rates will also decrease, given the new policy mix with reduced inflationary expectations and the prospect of declining budget deficits. Such reduced interest rates will alleviate the charges on business and budgets, and would contribute to more appropriate exchange rates *vis-à-vis* third currencies, strengthening competitiveness and helping exports and investments and so recovery in the Community.

6. From the domestic side, the recovery must be supported by appropriate demand and supply-side policies and particularly by private and public investment in its broadest sense. After the serious deterioration of budgetary performances, the Commission and the national governments are convinced of the urgent need for budgetary consolidation, the timing and pace of which depend very much on the degree and seriousness of the budgetary problem in each country and on the point in the cycle where Member States currently find themselves. The Social Partners for their part recognize that in the growth process it will be essential to put the deficits on a firmly and credibly declining medium and long-term trend in order to reach debt sustainability in a reasonable period of time. In order to immediately contribute to economic recovery, budget policies should try to switch expenditure towards investment and other more growth-enhancing activities. Further tax restructuring should be undertaken in favour of creating a level playing-field in the single market. Furthermore, in line with their July 1992 opinion, the Social Partners ask the Commission and the Council to accelerate and strengthen the implementation of the growth initiative decided at Edinburgh and extended at Copenhagen. Cofinancing by the Community via the European Investment Bank, the European Investment Fund and similar facilities should be developed and exploited. Investment in trans-European networks enhances the productivity and competitiveness in the internal market. Such a growth orientation of economic policies would help collective bargainers to make their contribution to recovery.

7. Macroeconomic policies must be complemented by policies designed to overcome structural problems which hinder efficient and competitive economic performances and a higher employment content of growth. The flexibility of goods and factor markets, including the labour market, has to be enhanced. Moreover, the following policies, in particular, should be pursued:

(i) the full completion of the single market and the even-handed enforcement of its rules;

(ii) the implementation of an effective European competition policy;

(iii) exploiting the advantages of an open international environment, especially by a rapid conclusion of the GATT negotiations;

(iv) making investment in technological innovation more efficient and speeding-up the application and dissemination of results;

(v) facilitating the taking of risks and initiatives and helping the small and medium-sized enterprises to play their role, especially in the creation of jobs;

(vi) accelerating the improvement of the infrastructure through trans-European networks not only in the Community and the EEA but also with the Council for European Economic Cooperation (CEEC);

(vii) developing the Community's social dimension, so as to ensure the active support of people for the process of change.

8. With respect to the functioning of the labour market, this is an area where the Social Partners themselves have special competence and responsibilities, and they have jointly made relevant proposals in several joint opinions. They have always emphasized the importance of active labour market policies removing employment obstacles, and of a well trained labour force which could adapt flexibly to technological and organizational changes. Hence, a broad general education and an adequate training are essential for everyone and, especially, for disadvantaged groups among young people and the long-term unemployed. In order to make our economies more competitive and to help increase the employment content of growth, labour market changes will be required. The Social Partners are prepared to discuss labour market flexibility in all its aspects. Increasing insecurity and particularly the fear of unemployment is an important factor in the lack of confidence in the European economies which is holding back recovery. In discussing the necessary reforms, the Social Partners will bear in mind that the successful management of fundamental change which the current situation imposes can better be achieved by partnership than by conflict and coercion.

9. The Social Partners stress the importance of this first application of Article 103(2) of the Treaty on European Union which is designed to create a coherent framework

for a coordinated strategy. They will regularly review the implementation of the proposed growth strategy in order to assess whether the resulting economic performance corresponds to the agreed objectives. They will communicate and discuss their observations and conclusions with the competent authorities at Community and national level. They will seek to overcome differences by drawing on a common attachment to long-standing European values and to the process of European integration. They are convinced that the resolute and sustained commitment to the broad guidelines on economic policies they have supported above, will help create the conditions in which growth, competitiveness, employment and real convergence can be reconciled with stability and nominal convergence.

V — Technical annex: Scenarios to 2000

The broad policy guidelines proposed by the Commission and adopted by the Council provide the framework for a policy environment conducive to growth and employment. In fact, the same policy principles may also be found in the macroeconomic chapter (Chapter 1, Part B) of the White Paper and in the Annual Economic Report for 1993.

At first glance, these policy recommendations may sound restrictive in their insistence on budget consolidation, stability-oriented monetary policies and wage moderation. Yet, the analysis of the former two decades shows that low inflation and stable exchange rates, together with an adequate level of public savings and profitability are key elements in the restoration of the confidence and will to invest of the private sector and, therefore, in the strengthening of the future growth potential of the Community.[1]

Indeed, strong employment-creating growth cannot be obtained by decree. It can only result from the dynamism of market forces supported by an adequate policy stance. Past experience shows that when policies follow an appropriate stance, growth is possible and sustainable.

Past experience also reveals that when policies are implemented in a consistent way, medium-term model projections are able to predict growth in a reasonably accurate way. Two examples, drawn from relatively recent periods and not very dissimilar from the present one in terms of fundamentals, highlight this point. The first is represented by the medium-term projections made in February 1983 by the services of the Commission for the period 1982-86 and the second by those produced in October 1985 (at the time of the presentation of the 'cooperative growth strategy') which cover the period 1986-90 (see the table below).

On the strength of these considerations, this annex presents, essentially in qualitative terms completed with tables and graphs, four scenarios (simulated with the QUEST model) that illustrate policy options ranging between two extreme alternative courses: (i) non-convergence and stagnation, or (ii) revival of a convergent, strong and employment-creating growth pattern, assuming the effective implementation of the broad policy guidelines adopted on 13 December 1993. In broad terms, the high-growth scenarios illustrate how to overcome the two macroeconomic obstacles to growth presented in Part A, Chapter III: Framework for the broad economic policy guidelines (page 13) and put in evidence how to make growth more employment-creating.

The Community now represents nearly 30% of world GDP and 40% of world trade, but this does not mean that it cannot be significantly influenced by outside developments. In order to emphasize the internal implications of the scenarios, the external environment is assumed to be 'neutral' (i.e. stability of real exchange rates and raw material prices, no major crises in LDCs, a slow but progressive recovery in East European countries, growth stabilized at potential for the USA and Japan, trend growth of world trade).

1. The cost of non-convergence

1.1. Scenario 1

This scenario was not conceived as a politically realistic scenario but as a tentative measurement of a 'do nothing' anti-world. In this scenario, therefore, there are no autonomous budget consolidation efforts beyond the slight automatic stabilizer effects of a mediocre recovery, wage growth remains high both in nominal and in real terms and monetary policy remains severely constrained towards a deflationary bias by the persistence of an unbalanced policy mix.

According to this 'non-convergence' scenario (Table 3), the absence of fiscal consolidation and wage moderation would lead to small, temporary gains in growth in 1994-95 compared with the scenarios involving better convergence, but these would be quickly destroyed by the crowding-out of private investment, the acceleration of inflation and the rise

[1] For a more in-depth analysis of growth fundamentals and of their linkages with economic policies, see the Annual Economic Report for 1993, Analytical Study No 1, *European Economy*, No 54, 1993, pp. 93-120.

	1983	1984	1985	1986	1987	1988	1989	1990
Actual GDP growth	1,6	2,3	2,5	2,8	2,9	4,2	3,5	3,0
Projections of February 1983	1,1	2,2	2,5	2,6				
Scenario of October 1985				2,7	3,1	3,9	3,6	2,8

in unemployment beyond 12% of the labour force. Growth rates would stagnate in the 2% range, leaving unsolved the public debt and unemployment issues, with considerable risks of social tension and 'beggar-thy-neighbour' policies. In addition, such a scenario would leave no hope of stabilizing intra-EC parities, effectively putting an end to the EMU process. In short, the Community would be plunged into the deeply divergent conditions that prevailed 20 years ago, after the first oil price shock, but with a much worse social situation.

2. Progressive achievement of a high, employment-creating growth pattern

2.1. Scenario 2

The starting point for the construction of a high-growth scenario is constituted by the extension of the Commission's official forecasts for 1993-95 to 2000 (Scenario 2, Table 4).[1] For this extension, it is assumed that member countries would return, as soon as growth picks up, to the convergence path defined in the convergence programmes presented in 1991-92. However, since starting conditions are now very different from those of the programmes, the medium-term projection only uses the path defined for policy instruments (public consumption, transfers and investment, tax rates, etc.) and does not necessarily reach the same end-results in terms of budget deficits as initially planned by the national authorities.

In this scenario, wage increases are kept moderate by the impact of high unemployment and by the nominal convergence policies followed in that field by some member countries. The return towards low wage and price inflation together with the budget consolidation efforts would also enable monetary policy to be neutral rather than restrictive. In the same way, the credibility of the convergence policies would restore exchange-rate stability within the Community. The policy mix in this scenario would thus already be very close to the optimal one recommended in the guidelines.

For practically all countries, nominal convergence would be reached for inflation and interest rates in 1996 at the latest and for budget deficits in 1997 or 1998. However, unemployment would only start to decrease in 1996 and the unemployment rate would still be 7,5% in 2000.

[1] These projections were discussed by the Medium-term Expert Group at its meeting of 17 September 1993 and were found consistent with the policy assumptions made. In a nutshell, the growth recovery would in this scenario remain very progressive (2% in 1995 and 3% in 1996) but would stabilize in a sustainable way (in terms of productive potential) at 3,5% from 1997 to 2000.

2.2. Scenario 3

In a second step, measures were introduced that try to improve both the employment perspective and the global policy mix. Two kinds of actions were considered (Table 5):

(i) in order to improve the medium-term perspective for growth and employment, it is assumed that a social consensus would be reached (in a centralized or decentralized way according to countries' traditions) that would lead to the same wage moderation as in 1982-89, i.e. a growth of real wage-cost per wage earner remaining on average 1 percentage point below the growth of labour productivity (real GDP per person employed) between 1994 and 2000. As in the 1980s, this would initially somewhat depress private consumption but in the medium term would increase investment (via profitability effects) and employment. In nominal terms, wages would also grow at a rate fully compatible with the inflationary targets of monetary authorities;

(ii) in order to compensate for the delay in economic recovery that an increased wage moderation would imply in 1994-95, the Edinburgh growth initiative is strengthened to an amount of ECU 30 billion both in 1994 and 1995 (60 billion cumulatively) in public works of Community interest and related fields. Given the low rate of capacity utilization in those years, no inflationary pressure should be expected of this package that would therefore fully support final demand without adverse effects and would improve the logistic environment for private investment and thus would also improve the growth potential.

The end result is, as expected, a slightly faster rate of sustainable GDP growth (3,7% on average from 1997 to 2000) and a gain of 1,5 percentage points in the unemployment rate in 2000 (6,0% as against 7,5% in Scenario 2).

2.3. Scenario 4

The final step was the introduction in Scenario 3 of structural measures that would increase the employment intensity of growth (Tables 6 and 7). Scenario 4 is technically the most difficult variant since it constitutes a macroeconomic evaluation of microeconomic policies related to labour market functioning.

In particular, it is assumed that a socially acceptable degree of increased flexibility, a development of the service sector and a reduction in employers' social security contributions on the lowest wages, financed by increases in other forms of taxation, would increase the employment intensity of growth by about half a point. In other words, the average growth of employment associated with a GDP growth of 3,5% would become 2,0% rather than 1,5% as in the previous scenarios.

As before, the evolution of the real wage-cost per head would remain one point below productivity and thus limited to 0,5% per year rather than 1%, but, given the stronger growth of employment, the total wage bill evolution remains the same as in Scenario 3 and there is thus very little change in the growth of GDP and its components.

On the labour market, however, it may be expected that the increased flexibility and lower wage-cost for the low-skilled would bring back into the labour force those formerly priced out of it as well as attracting new entrants. The growth of the active population would thus accelerate from 0,5 to 0,6% per year but thanks to the increased labour intensity of growth, the unemployment rate could, nevertheless, fall to 4,5% at the end of the period.[1]

This last high-growth scenario (Scenario 4), remains compatible with the European social model and with the responsibilities of the Community *vis-à-vis* LDCs and East European countries since EC imports from these areas will remain high.

It should, of course, be kept in mind that this favourable scenario, as appealing as it might be, implies very stringent requirements for public policies and private behaviour, together with the need for strong coordination at the Community level.

3. Reconciling growth, employment and convergence

In the terminology of theoretical growth models, the growth pattern just outlined represents a typical case of intertemporal optimization where the sacrifices made today[2] pave the way for a higher growth potential in the future. Thus, the apparent paradox of high growth created by fiscal consolidation and wage moderation is solved in the medium term by the increase in national savings and investment and by increased profitability of private output and capital, together with the positive confidence effects emanating from a credible and predictable medium-term policy mix.[3] It should also be remembered that the automatic stabilizers will play both ways: as soon as growth and employment pick up, tax receipts return to normal and social transfers decrease, accelerating the pace of deficit reduction beyond the impact of discretionary decisions. In the same way, the increased proportion of employed people in the population of working age enables a satisfactory evolution to occur in total wages and disposable incomes despite the moderate evolution of individual wages. Finally, improved competitiveness will strengthen the contribution of external trade to growth.

It is worth remembering that a high-growth, high-employment scenario was indeed achieved by the Community in 1985-90. This evolution was initially based (from around 1982 onwards) on the same policy mix that is presently contained in the broad policy guidelines and has been accepted by all Member States when they have adopted the 1993 Annual Economic Report:[4]

(i) fiscal consolidation aiming at debt sustainability and at restoring a positive public savings contribution to the overall savings/investment balance;

(ii) a moderate nominal and real wage evolution which is compatible with the inflation targets of the monetary authorities and which supports investment profitability;

(iii) a neutral monetary policy capable of ensuring price and exchange-rate stability without an undue deflationary bias, thanks to the support of the other policies and behaviours.

Unfortunately this growth pattern was interrupted from 1990 onward when unemployment had been reduced only by about one quarter (from 10,8% in 1985 to 8,3% in 1990). The still relatively low potential rate of growth of the Community's economy carries part of the responsibility for this interruption, but the largest single cause for the present recession is represented by the policy errors which were made in responding to the shocks that hit the Community's economies in the second half of the 1980s (1987 stock market crash, German unification).

The stronger growth/higher employment content scenario (Scenario 4) is globally much easier to realize than any low-growth/low-productivity scenario. In fact, the only element in the most favourable scenario that has not yet been

1 At the level of member countries, the amount of effort and sacrifice would vary according to their starting positions in terms of convergence.
2 Moderate growth of wages and public current expenditure in order to ensure a high rate of investment in future productive potential (and, hence, future real income and wealth) rather than present consumption.
3 Economic agents are more and more conscious that present increases (decreases) in public indebtedness mean future increases (decreases) in tax pressures and adapt their expenditure plans accordingly.
4 Annual Economic Report for 1993, Section IV.2. *European Economy*, No 54, 1993, pp. 20-23.

achieved in the very recent past is a moderate increase in the labour intensity of growth. Given the order of magnitudes, it can certainly be reached without breaking the European model of social consensus and could indeed gain, without undue efforts, the agreement of the Social Partners[1] ('concerted flexibility' versus 'enforced flexibility' plus some 'fiscal engineering' between employers' social contributions on the one hand and other taxes like a CO_2 tax on the other hand, in order to reduce the relative cost of unskilled labour without reducing net revenues).

If the policy mix and growth pattern outlined above are rapidly achieved, and maintained with determination, the Community will be able to reconcile low inflation and the Maastricht nominal convergence targets with an improved growth-employment pattern and the realization of real convergence.

[1] See the joint opinion of the European Social Partners, this issue, Part A, Chapter IV, pp. 19-21.

Table 1

Selected supply and demand indicators, European Community,[1] 1961-92

(Annual % change, unless otherwise stated)

	1961	1961-73	1974	1974-80	1981	1981-85	1986	1986-89	1990	1991	1992
1. Real GDP growth	5,5	4,7	1,9	2,3	0,1	1,4	2,8	3,3	3,0	1,4	1,0
2. Employment	0,7	0,3	0,4	0,2	−1,1	−0,4	0,7	1,3	1,7	0,2	−0,6
3. Labour productivity	4,8	4,4	1,5	2,1	1,2	1,8	2,1	2,0	1,3	1,2	1,6
4. Unemployment rate (% of civilian labour force)	2,2	2,2	2,8	4,8	7,7	9,6	10,7	9,9	8,3	8,7	9,3
4a. Activity rate (% of population of working age)	68,6	66,8	66,4	66,2	66,0	65,4	65,4	65,9	66,3	66,4	66,2
5. Consumption price	2,8	4,6	14,9	12,1	12,1	8,9	3,8	4,0	4,5	5,4	4,4
6. GDP deflator	3,2	5,2	13,3	12,2	10,9	8,5	5,6	4,8	5,2	5,3	4,4
7. Public deficit (% of GDP)	0,5	−0,5	−2,4	−3,8	−5,0	−5,1	−4,5	−3,7	−4,0	−4,7	−5,0
8. Public debt (% of GDP)	:	:	:	40,9	45,4	52,7	59,4	60,1	57,2	58,8	61,8
9. Public investment (% of GDP)	3,4	3,5	3,8	3,4	3,0	2,8	2,8	2,7	2,9	2,9	2,9
10. Nominal wage/head	8,8	9,8	17,9	15,0	13,0	9,6	6,3	5,7	7,4	7,0	5,8
11. Real gross wage/head	5,4	4,4	4,1	2,5	1,9	1,0	0,7	1,0	2,1	1,6	1,3
12. Real unit labour cost	0,6	0,0	2,5	0,4	0,7	−0,7	−1,4	−1,0	0,8	0,4	−0,2
13. Profitability index (1961-73 = 100)	101,7	100,0	79,0	72,4	63,3	69,1	81,2	85,2	90,0	88,6	88,2
14. Real long-term interest rate (deflated with GDP deflator)	2,2	1,8	−0,7	0,2	4,1	4,4	3,4	4,5	5,5	5,0	5,2
15. Capital/output ratio	3,0	3,0	3,1	3,3	3,4	3,5	3,4	3,4	3,4	3,4	3,4
16. Share of investment in GDP	22,4	23,2	23,7	22,1	20,9	19,7	19,0	19,8	20,8	20,2	19,6
17. Fixed capital stock	4,9	4,9	4,2	3,4	2,6	2,2	2,2	2,5	3,0	2,8	2,6
18. Private consumption	5,5	4,9	1,7	2,7	0,4	1,3	4,2	3,8	3,1	1,9	1,7
19. Public consumption	4,7	3,7	2,8	2,8	1,8	1,7	2,3	1,9	2,0	1,5	1,7
20. Total fixed investment	9,6	5,5	−2,6	0,4	−5,1	−0,7	4,2	6,2	3,8	−0,3	−0,9
21. Exports	5,8	8,0	6,6	4,3	3,8	3,9	1,8	4,8	7,0	5,3	3,8
22. Final demand	5,6	5,3	2,7	2,5	0,9	1,6	2,5	4,2	3,8	2,3	1,9
Saving balances (% of GDP)											
23. Household savings	:	10,0	13,9	12,8	12,8	11,3	10,3	9,5	9,6	9,7	9,8
24. Corporate savings	:	11,0	7,8	8,9	8,0	9,7	11,3	11,6	11,8	11,1	11,2
25. Private savings (= 23 + 24)	:	21,0	21,7	21,7	20,8	21,0	21,6	21,1	21,4	20,8	21,0
26. Public savings	:	4,0	2,8	1,1	−1,0	−1,2	−0,8	−0,1	−0,3	−0,8	1,7
27. National savings (= 25 + 26)	24,7	25,0	24,5	22,8	19,8	19,8	20,8	21,0	21,1	20,0	19,3
28. Current balance	0,6	0,4	−0,9	−0,3	−0,6	0,0	1,3	0,5	−0,2	−0,3	−0,5
29. Gross capital formation (= 27 − 28)	24,1	24,6	25,4	23,1	20,4	19,8	19,5	20,5	21,3	20,3	19,8

[1] Including West Germany.
Source: Commission services.

Table 2

Structure of the general government account, national account definitions, European Community, observed values, 1970-92

(In ecus, as % of GDP)

	1970	1975	1980	1985	1986	1987	1988	1989	1990	1991	1992
Current receipts											
1. Indirect taxes	13,4	12,1	13,0	13,2	13,3	13,4	13,4	13,3	13,3	13,4	13,3
2. Direct taxes	9,6	10,7	11,6	12,5	12,3	12,5	12,4	12,8	12,6	12,8	12,5
3. Social security contributions	10,7	13,4	14,2	15,0	15,1	15,2	14,9	14,7	14,7	14,9	15,0
4. Other current receipts	2,8	2,9	4,0	3,8	3,4	3,2	3,3	3,3	3,4	3,5	
5. Total (1+2+3+4)	36,5	39,1	42,2	44,7	44,5	44,5	43,9	44,1	43,9	44,5	44,3
Current expenditure											
6. Total transfers	14,6	19,0	20,0	21,8	21,7	21,6	21,0	20,7	21,1	22,1	22,5
6a. Of which: subsidies	1,8	2,4	2,6	2,7	2,7	2,7	2,5	2,3	2,2	2,1	2,0
7. Actual interest payments	1,8	2,1	3,1	4,9	4,9	4,7	4,6	4,7	4,9	5,0	5,3
8. Government consumption	15,0	17,8	18,5	18,9	18,6	18,6	18,4	17,9	18,0	18,2	18,2
9. Total (6+7+8)	31,4	38,9	41,6	45,6	45,2	44,9	44,0	43,3	44,0	45,3	46,0
10. Public gross saving (5−9)	5,1	0,2	0,6	−0,9	−0,7	−0,4	−0,1	0,8	−0,1	−0,8	−1,7
11. Net capital transfers	0,8	1,0	1,0	1,0	0,9	0,9	0,8	0,7	0,9	1,0	0,4
12. Gross fixed capital formation	4,1	3,9	3,2	2,8	2,8	2,7	2,6	2,8	3,0	2,9	2,8
13. Total expenditure (9+11+12)	36,3	43,8	45,8	49,4	48,9	48,5	47,4	46,8	47,9	49,2	49,2
14. Net lending (+) or borrowing (−) (5−13 = 10−11−12)	0,2	−4,7	−3,6	−4,7	−4,4	−4,0	−3,5	−2,7	−4,0	−4,7	−4,9
15. Gross public debt	:	:	38,9	55,3	56,1	57,7	57,2	56,5	57,2	58,8	61,8

Table 3

Scenario 1: Low growth and non-convergence, European Community,[1] 1993-2000

(Annual % change, unless otherwise stated)

	Average 1986-90[2]	1993	Average 1994-2000	Average 1995-2000	2000
1. Real GDP growth	3,2	−0,6	1,9	2,1	2,0
2. Employment	1,4	−2,3	0,2	0,3	0,3
3. Labour productivity	1,8	1,7	1,7	1,8	1,7
4. Unemployment rate (% of civilian labour force)	9,6	10,4	11,6	11,7	12,2
5. Activity rate (% of population of working age)	65,9	66,0	66,1	66,2	66,7
6. Public deficit (% of GDP)	−3,8	−6,2	−5,1	−5,0	−5,0
7. Public investments (% of GDP)	2,7	2,7	2,8	2,8	2,9
8. Nominal wage-cost per head	6,0	3,8	4,9	5,1	5,4
9. Real wage-cost per head (deflated with the GDP deflator)	1,1	0,4	1,4	1,6	1,8
10. Inflation (private consumption price)	4,2	3,7	3,5	3,5	3,5
11. Profitability index (1961-73 = 100)	86,6	86,3	88,1	88,2	86,7
12. Fixed investment share (% of GDP)	20,0	18,4	19,1	19,2	19,5
13. Fixed capital stock	2,6	2,3	2,4	2,4	2,5
14. Private consumption	3,6	−0,4	1,8	2,0	2,1
15. Private saving (% of GDP)	21,2	21,3	21,3	21,3	21,4
16. Public saving (% of GDP)	−0,1	−2,7	−1,5	−1,4	−1,3

[1] Including West Germany.
[2] Most recent long period of strong and employment-creating growth.
Source: Commission services.

Table 4

Scenario 2: Medium-term projection with nominal and real convergence, European Community,[1] 1993-2000

(Annual % change, unless otherwise stated)

	Average 1986-90[2]	1993	Average 1994-2000	Average 1995-2000	2000
1. Real GDP growth	3,2	−0,6	2,9	3,1	3,5
2. Employment	1,4	−2,3	1,0	1,2	1,5
3. Labour productivity	1,8	1,7	1,9	1,9	2,0
4. Unemployment rate (% of civilian labour force)	9,6	10,4	9,6	9,4	7,5
5. Activity rate (% of population of working age)	65,9	66,0	66,2	66,3	66,9
6. Public deficit (% of GDP)	−3,8	−6,2	−3,3	−2,9	−0,7
7. Public investments (% of GDP)	2,7	2,7	2,9	2,9	3,0
8. Nominal wage-cost per head	6,0	3,8	3,9	4,0	4,1
9. Real wage-cost per head (deflated with the GDP deflator)	1,1	0,4	1,2	1,3	1,5
10. Inflation (private consumption price)	4,2	3,7	2,8	2,7	2,5
11. Profitability index (1961-73 = 100)	86,6	86,3	92,8	93,6	97,0
12. Fixed investment share (% of GDP)	20,0	18,4	20,3	20,6	22,1
13. Fixed capital stock	2,6	2,3	2,9	3,0	3,6
14. Private consumption	3,6	−0,4	2,3	2,7	3,3
15. Private saving (% of GDP)	21,2	21,3	20,8	20,7	20,2
16. Public saving (% of GDP)	−0,1	−2,7	0,2	0,7	2,9

[1] Including West Germany.
[2] Most recent long period of strong and employment-creating growth.

Source: Commission services.

Table 5

Scenario 3: Scenario 2 with more wage moderation and 'Edinburgh II', European Community,[1] 1993-2000

(Annual % change, unless otherwise stated)

	Average 1986-90[2]	1993	Average 1994-2000	Average 1995-2000	2000
1. Real GDP growth	3,2	−0,6	3,1	3,4	3,6
2. Employment	1,4	−2,3	1,2	1,4	1,6
3. Labour productivity	1,8	1,7	1,9	2,0	2,0
4. Unemployment rate (% of civilian labour force)	9,6	10,4	9,1	8,7	6,0
5. Activity rate (% of population of working age)	65,9	66,0	66,3	66,4	66,7
6. Public deficit (% of GDP)	−3,8	−6,2	−3,8	−3,5	−0,8
7. Public investments[3] (% of GDP)	2,7	2,7	3,4	3,4	3,5
8. Nominal wage-cost per head	6,0	3,8	3,5	3,5	3,8
9. Real wage-cost per head (deflated with the GDP deflator)	1,1	0,4	0,8	1,0	1,2
10. Inflation (private consumption price)	4,2	3,7	2,6	2,5	2,5
11. Profitability index (1961-73 = 100)	86,6	86,3	94,6	95,7	100,8
12. Fixed investment share (% of GDP)	20,0	18,4	20,9	21,2	22,9
13. Fixed capital stock	2,6	2,3	3,1	3,2	3,8
14. Private consumption	3,6	−0,4	2,2	2,6	3,2
15. Private saving (% of GDP)	21,2	21,3	21,9	21,9	21,9
16. Public saving (% of GDP)	−0,1	−2,7	0,2	0,6	3,4

[1] Including West Germany.
[2] Most recent long period of strong and employment-creating growth.
[3] Including 'Edinburgh II' package.

Source: Commission services.

Table 6

Scenario 4: High-growth scenario (Scenario 3 with structural measures), European Community,[1] 1993-2000

(Annual % change, unless otherwise stated)

		1993	1994	1995	1996	Average 1994-2000	Average 1995-2000	2000
1.	Real GDP growth	−0,6	1,5	2,2	3,1	3,1	3,3	3,6
2.	Employment	−2,3	0,1	0,7	1,7	1,6	1,9	2,2
3.	Labour productivity	1,7	1,4	1,5	1,5	1,5	1,5	1,5
4.	Unemployment rate (% of civilian labour force)	10,4	10,6	10,5	9,6	8,0	7,6	4,5
4a.	Activity rate (% of population of working age)	66,0	65,6	65,8	66,1	66,4	66,6	67,5
5.	Consumption price	3,7	3,3	2,7	2,5	2,6	2,5	2,5
6.	GDP deflator	3,4	3,1	2,5	2,5	2,6	2,5	2,6
7.	Public deficit (% of GDP)	−6,2	−6,1	−5,9	−4,9	−3,9	−3,5	−0,8
8.	Public debt (% of GDP)	66,2	70,6	76,8	78,3	75,7	76,6	72,7
9.	Public investment[2] (% of GDP)	2,8	3,3	3,8	3,2	3,4	3,4	3,5
10.	Nominal wage/head	3,8	3,2	2,8	3,0	3,0	3,0	3,1
11.	Real gross wage/head	0,4	0,1	0,3	0,5	0,4	0,5	0,5
12.	Real unit labour cost	−1,3	−1,3	−1,2	−0,9	−1,0	−1,0	−1,0
13.	Profitability index (1961-73 = 100)	86,3	87,7	89,6	92,1	94,6	95,7	100,8
14.	Real long-term interest rate (deflated with GDP deflator)	4,3	3,7	3,9	3,8	3,8	3,8	3,7
15.	Capital/output ratio	3,4	3,4	3,4	3,4	3,4	3,4	3,4
16.	Share of investment in GDP	18,4	18,9	19,3	20,2	21,0	21,3	23,1
17.	Fixed capital stock	2,3	2,4	2,5	2,8	3,1	3,2	3,8
18.	Private consumption	−0,4	0,2	1,1	2,2	2,2	2,6	3,2
19.	Public consumption	0,5	0,5	0,4	0,5	0,5	0,5	0,5
20.	Total investments	−5,3	3,7	4,4	7,5	6,3	6,7	6,1
21.	Exports	−1,3	3,5	5,8	6,3	5,9	6,3	6,5
22.	Final demand	−1,4	1,8	2,8	3,9	3,7	4,0	4,4
Saving balances (% of GDP)								
23.	Household savings	9,2	9,0	9,0	9,2	8,8	8,7	8,2
24.	Corporate savings	12,1	12,8	13,1	13,1	13,1	13,1	13,2
25.	Private savings (= 23 + 24)	21,3	21,8	22,1	22,3	21,9	21,9	21,3
26.	Public savings	−2,7	−2,4	−2,0	−1,0	0,2	0,6	3,4
27.	National savings (= 25 + 26)	18,6	19,4	20,1	21,3	22,1	22,5	24,7
28.	Current balance	0,0	0,2	0,4	0,6	0,7	0,7	1,0
29.	Gross capital formation (= 27 − 28)	19,1	19,2	19,7	20,7	21,4	21,8	23,7

[1] Including West Germany.
[2] Including 'Edinburgh II' package.
Source: Commission services.

Table 7

Structure of the general government account, national account definitions, European Community, 1993-2000 — Scenario 4: High-growth (Scenario 3 with structural measures)

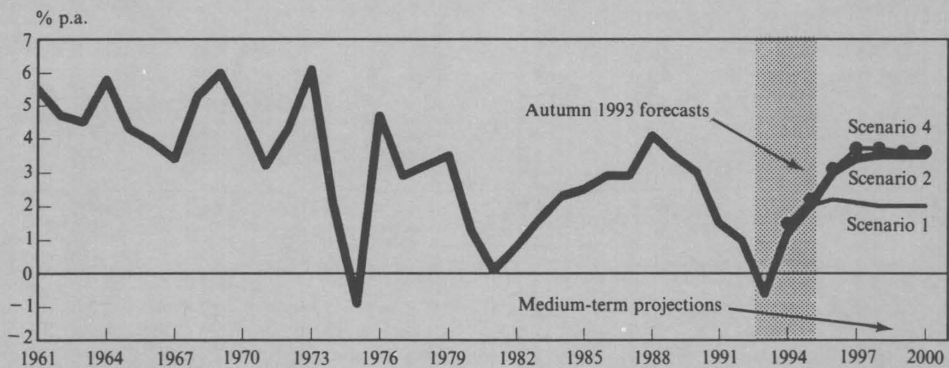
(In PPS, as % of GDP)

	1993	1994	1995	1996	1997	1998	1999	2000
Current receipts								
1. Indirect taxes	13,0	13,1	13,1	13,0	12,9	12,8	12,7	12,7
2. Direct taxes	12,3	12,1	12,3	12,5	12,8	13,1	13,3	13,7
3. Social security contributions	15,0	15,3	15,2	15,0	14,9	14,7	14,6	14,5
4. Other current receipts	3,5	3,5	3,5	3,5	3,5	3,5	3,5	3,5
5. Total (1+2+3+4)	43,8	44,0	44,1	44,0	44,1	44,1	44,2	44,3
Current expenditure								
6. Total transfers	23,1	23,3	23,2	22,9	22,6	22,3	21,9	21,5
6a. Of which: subsidies	2,0	2,0	1,9	1,8	1,7	1,6	1,5	1,4
7. Actual interest payments	5,4	5,3	5,4	5,1	4,9	4,8	4,5	4,3
8. Government consumption	17,9	17,8	17,5	17,0	16,5	16,0	15,5	15,1
9. Total (6+7+8)	46,4	46,4	46,1	45,1	44,1	43,0	41,9	40,9
10. Public gross saving (5−9)	−2,7	−2,4	−2,0	−1,0	0,0	1,1	2,2	3,4
11. Net capital transfers	0,7	0,8	0,8	0,8	0,8	0,8	0,8	0,8
12. Gross fixed capital formation[1]	2,8	3,3	3,8	3,2	3,3	3,4	3,5	3,5
13. Total expenditure (9+11+12)	49,9	50,5	50,7	49,1	48,2	47,2	46,2	45,2
14. Net lending (+) or borrowing (−) (5−13 = 10−11−12)	−6,2	−6,1	−5,9	−4,9	−4,1	−3,1	−2,0	−0,8
15. Gross public debt	66,2	70,6	76,8	78,3	78,5	77,6	75,7	72,7

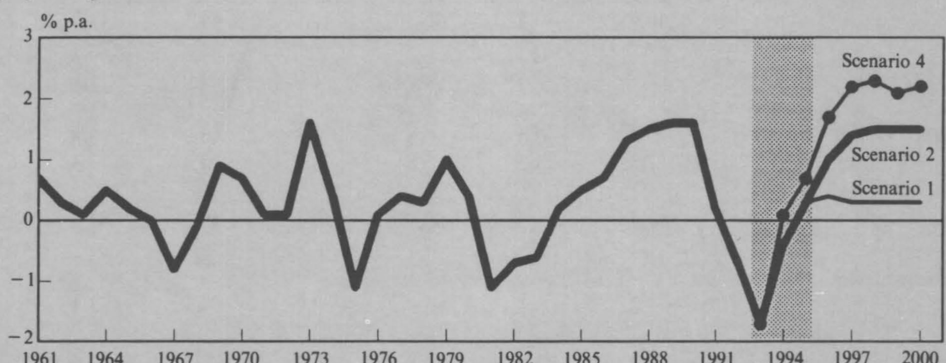
[1] In 1994-95, includes 'Edinburgh II' package (ECU 30 billion each year) two-thirds financed by the private sector and thus only partly included in the net borrowing total.

European Community short and medium-term outlook

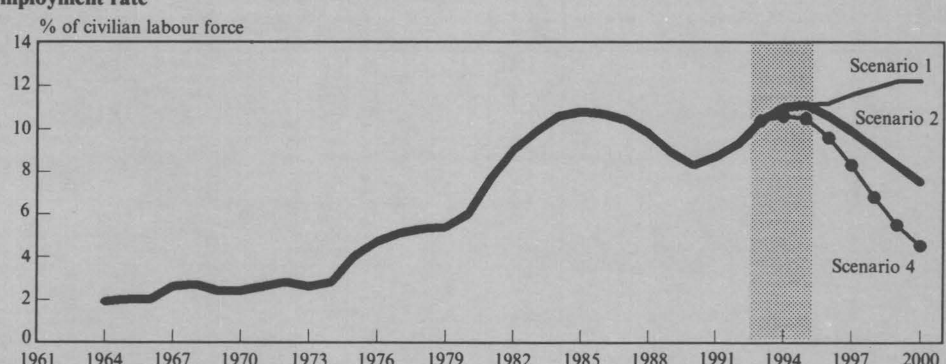
GRAPH 1: **Real GDP growth**



GRAPH 2: **Employment growth**

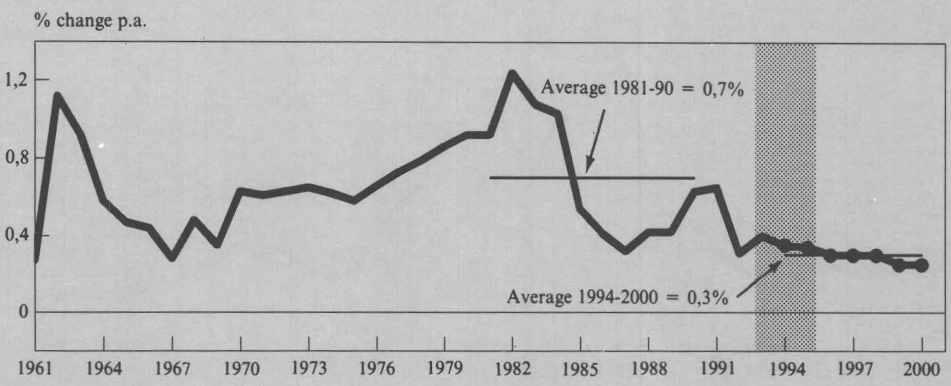


GRAPH 3: **Unemployment rate**

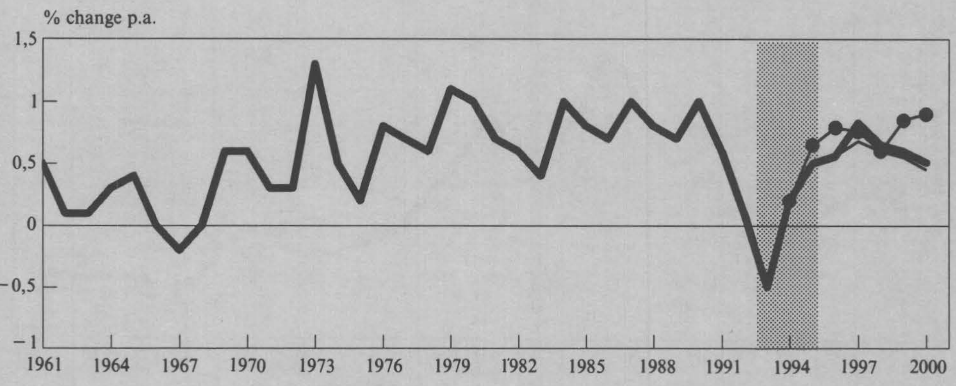


EUR 12 excluding the five new German *Länder*.
Scenario 1: Slow growth and non-convergence.
Scenario 2: Medium-term outlook with nominal and real convergence.
Scenario 4: High and employment-creating growth.
Source: Commission services.

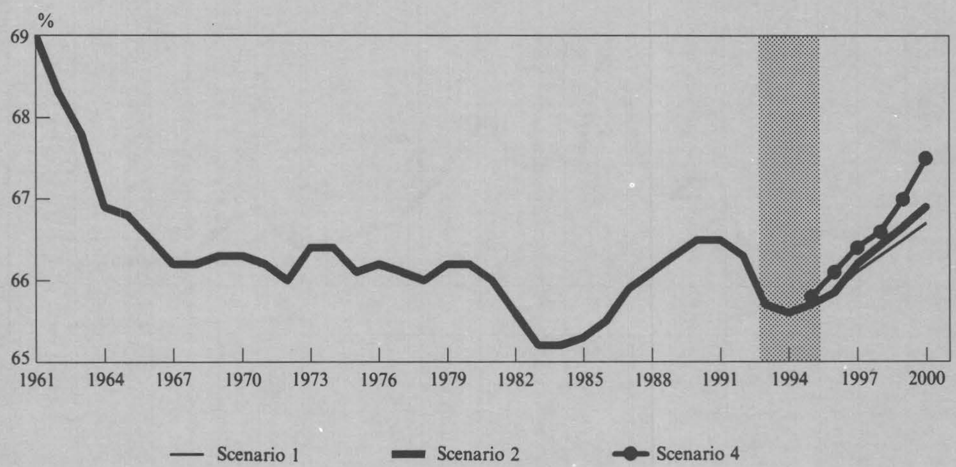
GRAPH 4: **Population in active age (15-64 years)**



GRAPH 5: **Active population**

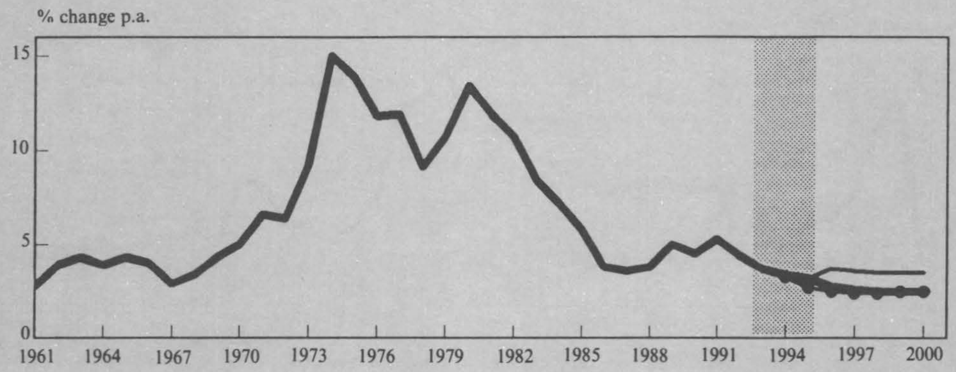


GRAPH 6: **Participation rate**

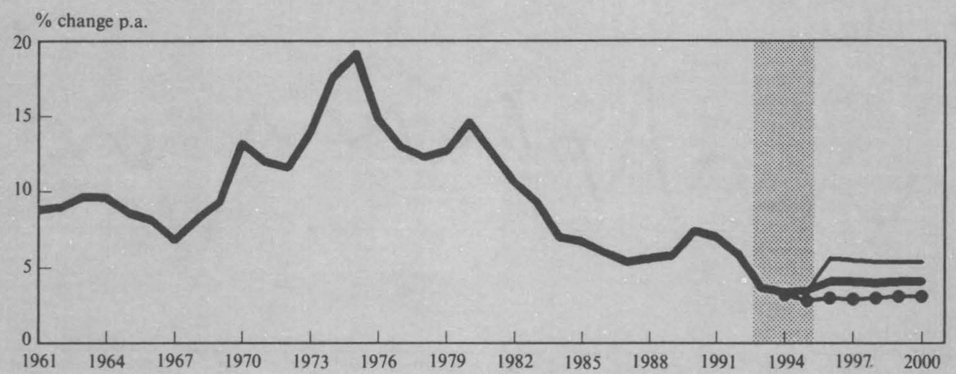


EUR 12 excluding the five new German *Länder*.
Source: Commission services.

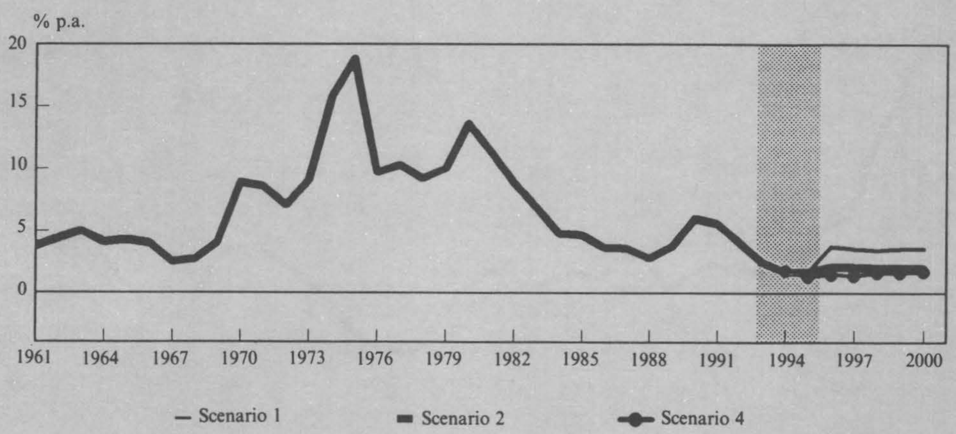
GRAPH 7: **Inflation (private consumption deflator)**



GRAPH 8: **Nominal wages**

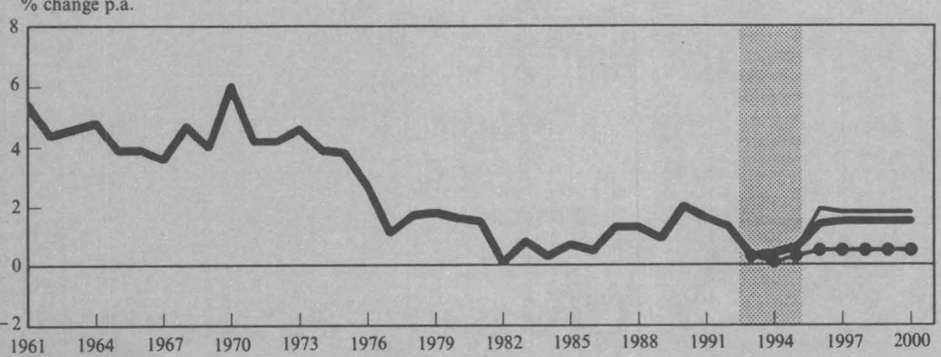


GRAPH 9: **Nominal unit labour costs**

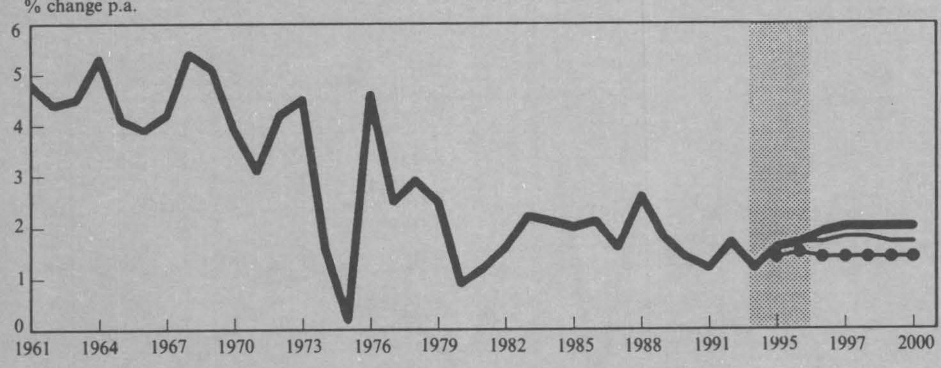


EUR 12 excluding the five new German *Länder*.
Source: EC Commission services.

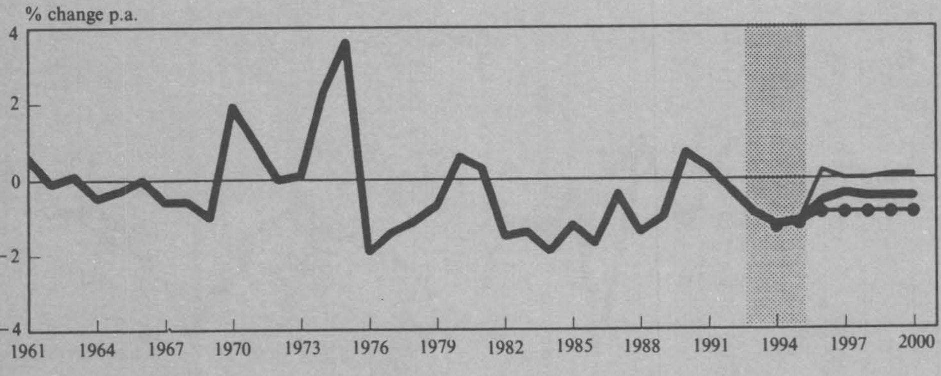
GRAPH 10: **Total real wage costs per head (deflated by GDP deflator)**



GRAPH 11: **Labour productivity (GDP per person employed)**



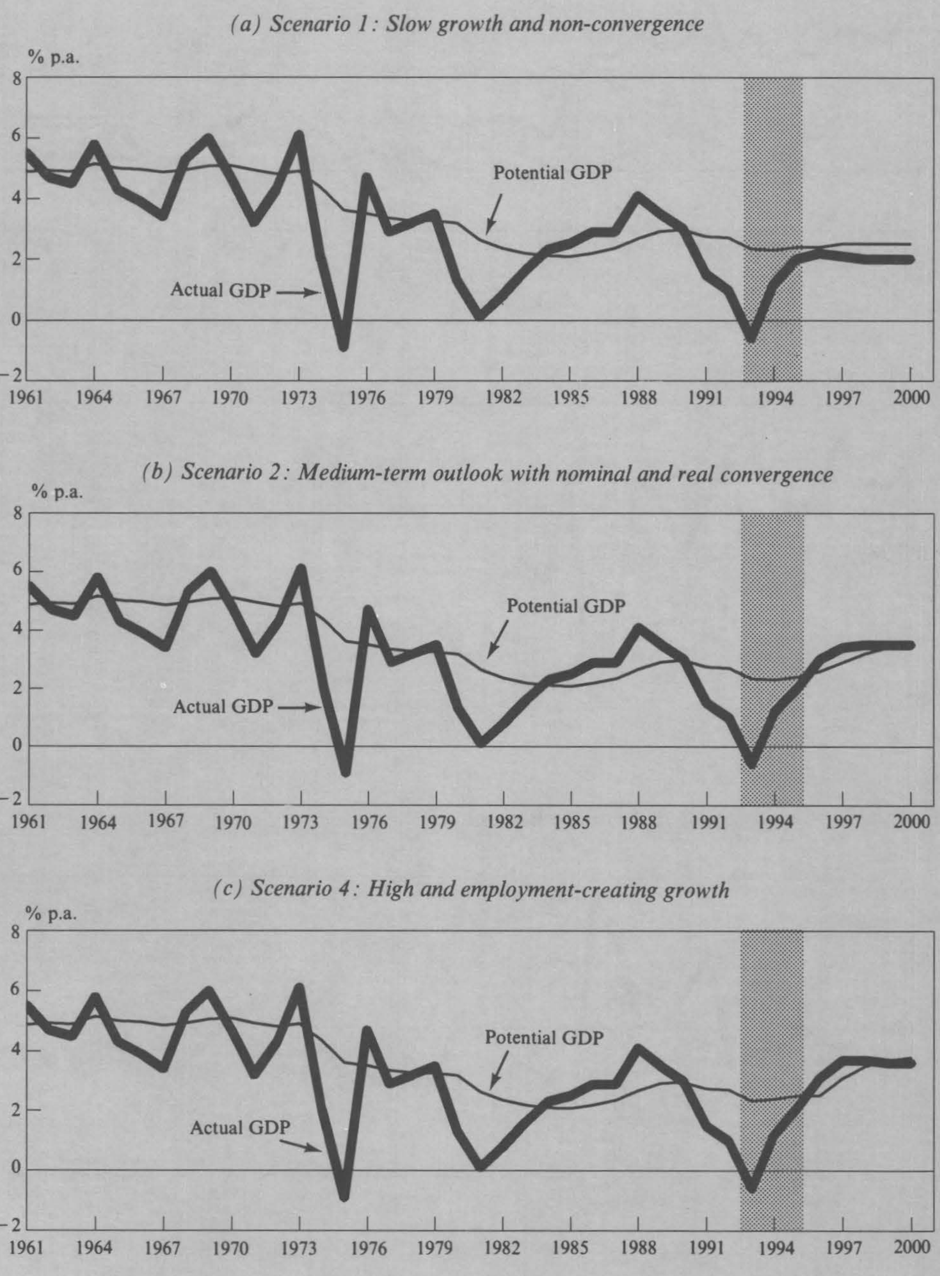
GRAPH 12: **Real unit labour costs (index of 10 divided by index of 11)**



— Scenario 1 ▬ Scenario 2 -●- Scenario 4

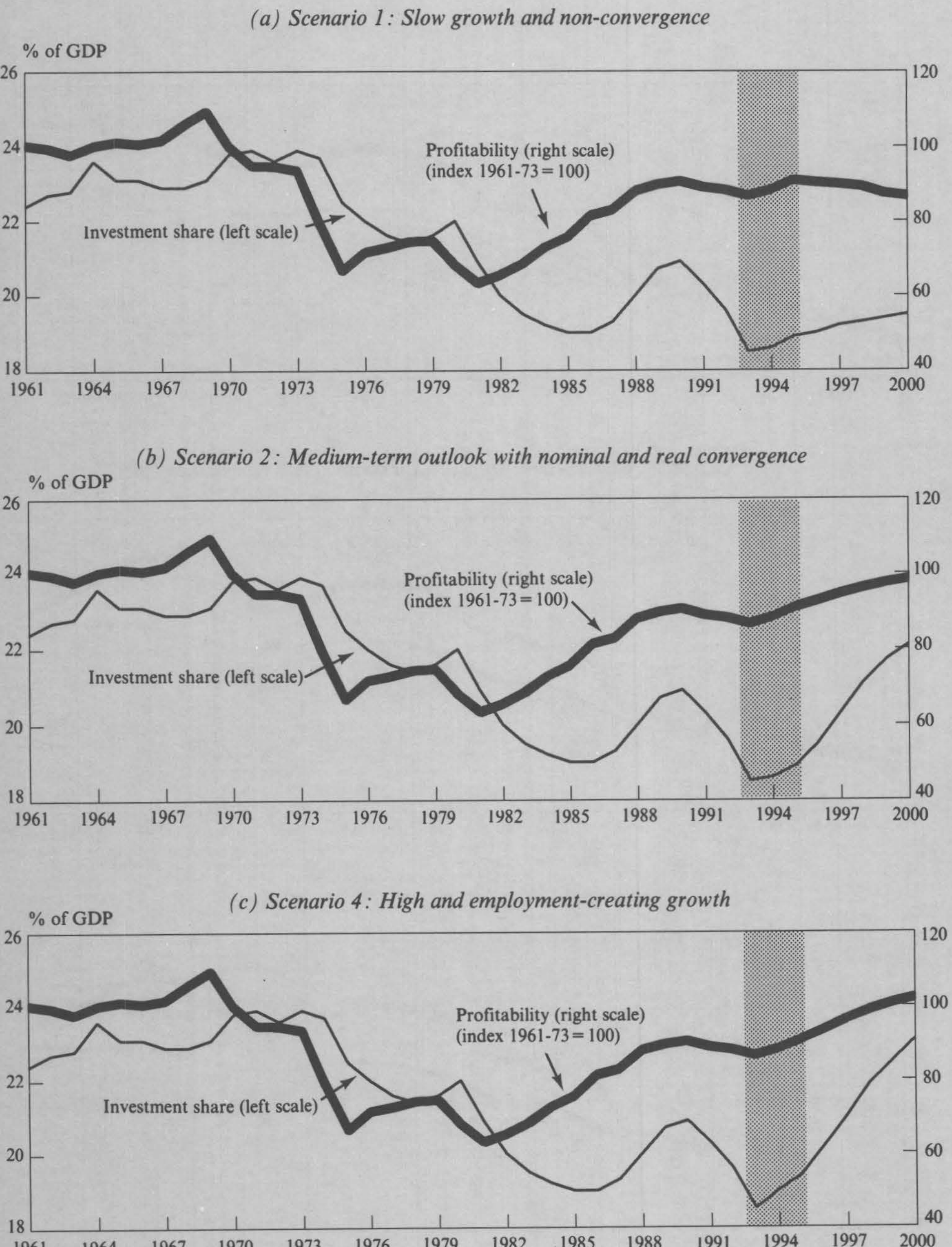
EUR 12 excluding the five new German *Länder*.
Source: Commission services.

GRAPH 13: **Actual and potential real GDP growth**



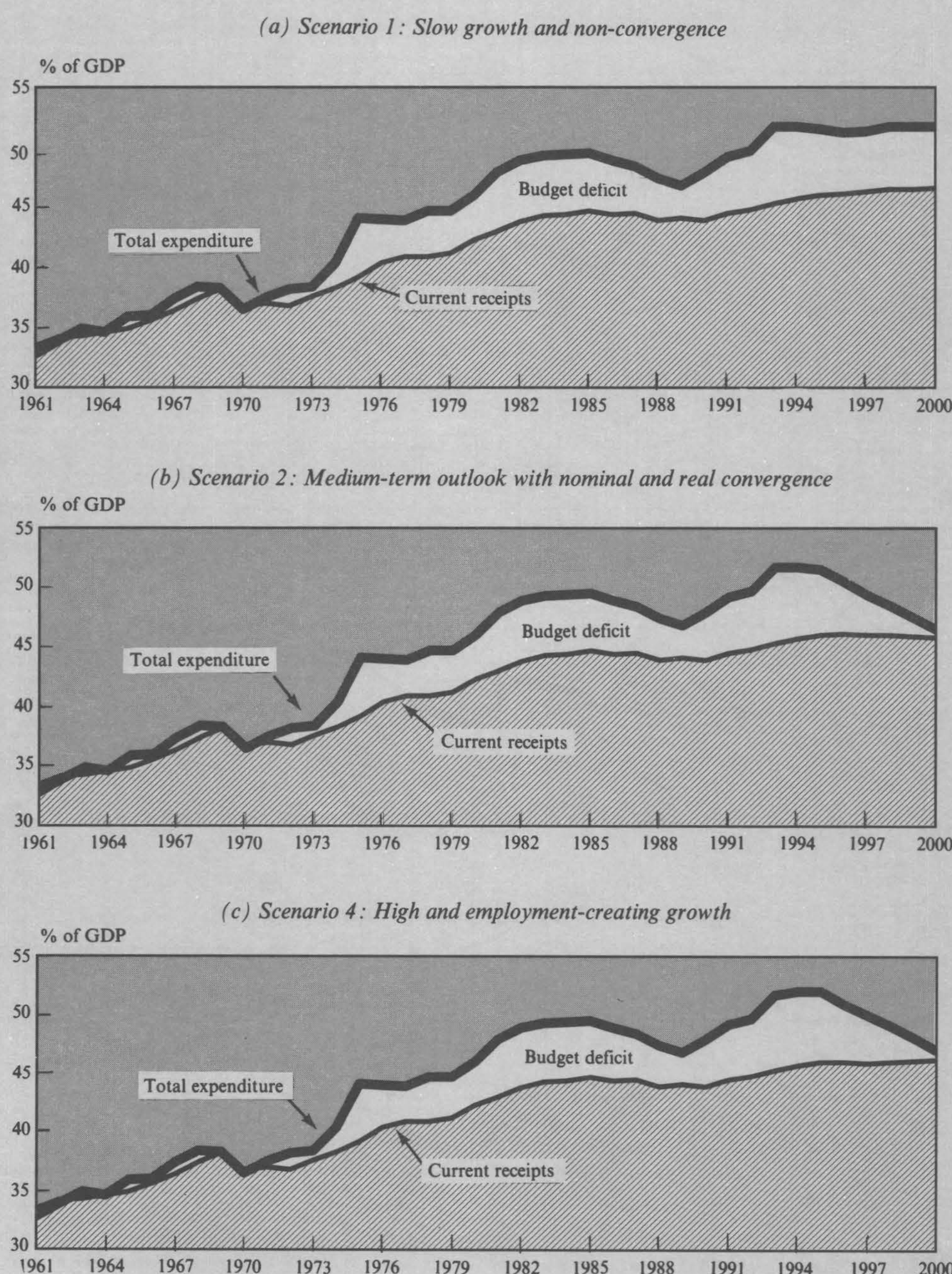
EUR 12 excluding the five new German *Länder*.
Source: EC Commission services.

GRAPH 14: **Profitability and investment share**



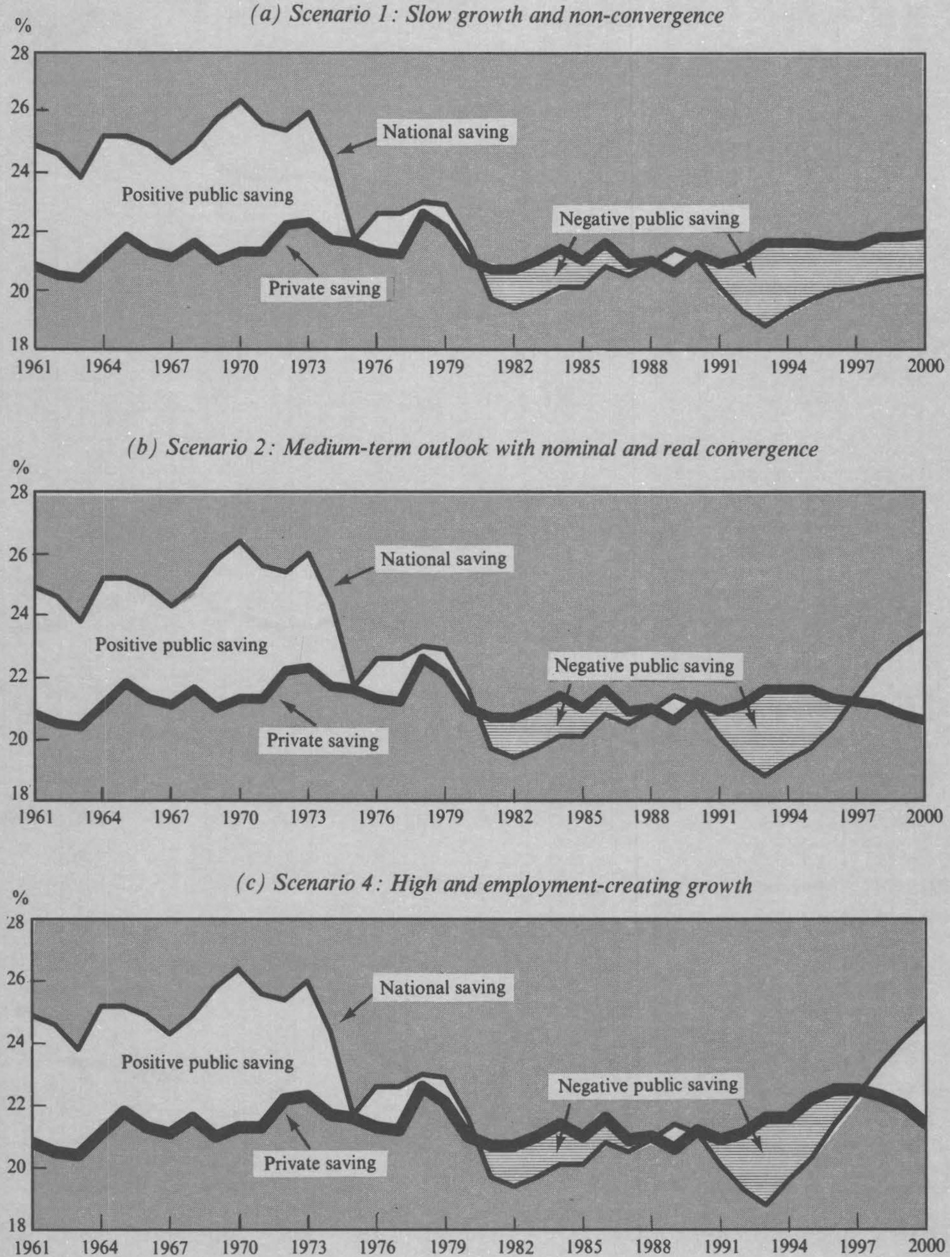
EUR 12 excluding the five new German *Länder*.
Source: Commission services.

GRAPH 15: **Budget deficit**



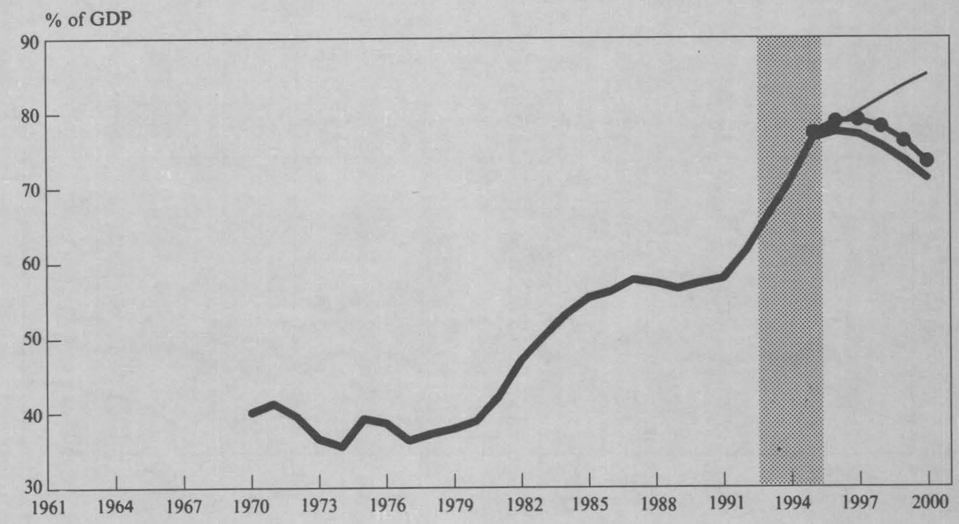
EUR 12 excluding the five new German *Länder*.
Source: Commission services.

GRAPH 16: **Private and public saving as a percentage of GDP**

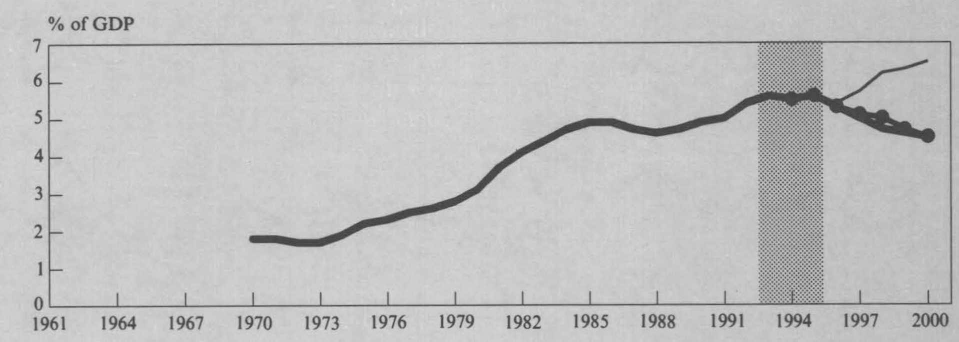


EUR 12 excluding the five new German *Länder*.
Source: Commission services.

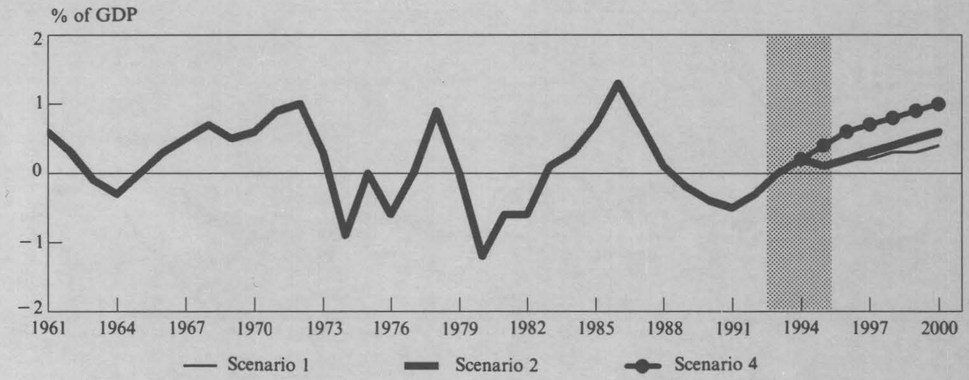
GRAPH 17: **Public debt**



GRAPH 18: **Interest payments on public debt**



GRAPH 19: **Current account balance**



EUR 12 excluding the five new German *Länder*.
Source: Commission services.

Part B

Report on progress with regard to economic and monetary convergence and with the implementation of Community law concerning the internal market

Contents

Tables

Graphs

Summary

Achieving a high degree of convergence is a precondition for moving to the final stage of economic and monetary union (EMU) as defined in the Treaty on European Union which entered into force on 1 November 1993. The second stage of EMU will start on 1 January 1994. The move to Stage II is not conditional on any particular achievements on convergence, neither economic nor institutional. However, the current state of play regarding economic and monetary convergence must be assessed in order to have a view of the progress made during Stage I. The Treaty requires the Council to make such an assessment, based on a report presented by the Commission (Article 109e(2)(b)); moreover, the Treaty requires the assessment to cover also the progress made with the implementation of Community law concerning the internal market. The attached report is intended to fulfil these Treaty requirements.

Progress in economic and monetary convergence during Stage I of EMU which started on 1 July 1990 was mixed: while on the inflation front there were positive developments, the same cannot be said about public finances. As regards real convergence, the progress achieved in improving supply conditions, namely through the implementation of the internal market programme, has been obscured by the sharp rise in unemployment and the stalling of the catching-up process in the Community.

These developments in convergence must be seen against the background of a much worse than expected economic situation. Indeed, following a marked deceleration of economic activity since the early 1990s the European Community entered into recession in mid-1992 (i.e. in the middle of Stage I). The European Monetary System (EMS), which is the cornerstone of monetary integration, was not immune to these developments and the period of high turbulence in the exchange rate markets which started in the summer of 1992 culminated in the significant widening of the fluctuation margins one year later; in between, two major currencies suspended their participation in the system and several realignments of parities took place. Finally, the recessionary context and the rise in unemployment made some structural weaknesses still prevailing in the Community more evident.

In spite of these adverse developments, which are in marked contrast with the expectations prevailing at the beginning of Stage I, Member States have remained committed to the convergence process and to the necessary structural reform. Convergence programmes have been adopted by most Member States and, in general, projected measures were implemented at least on the scale initially envisaged as necessary. Reforms geared to the removal of structural rigidities affecting their national economies were taken by all Member States, in welcome contrast with the past when they were frequently postponed. On the institutional front, the process of central bank independence has progressed clearly ahead of the Treaty requirements. Meanwhile, the completion of the internal market, which is the most ambitious structural reform at Community level, has been largely achieved. It is therefore fair to say that although economic developments during Stage I partly veil the results of the convergence efforts made by Member States, much was achieved in the structural and institutional fields. These achievements, although less visible, will provide strong support to a sound construction of EMU.

Visible progress was achieved in inflation performance during Stage I, both as regards the level and the degree of convergence. The inflation rates in 1993 in seven Member States are estimated to be within the limits to be aimed for according to the Treaty, which is of the order of 3 to 4% this year. Of these Member States, six have shown a remarkable regularity during the period (Belgium, Denmark, France, Ireland, Luxembourg and the Netherlands), while the United Kingdom has entered the reference range for the first time this year. As regards the remaining Member States, the somewhat poorer performance of Germany in the recent period has been mainly due to the special circumstances of unification; in Spain and Italy inflation has been decelerating and the 5% plateau has been broken this year; in Portugal inflation is now much closer to the reference range compared with the double-digit inflation in the early 1990s. Although progress has been achieved, inflation in Greece remains far above the Community average.

Member States' public finances deteriorated significantly during Stage I of EMU. It appears that fiscal policy has had to play a major role in accommodating the recession either through the working of the automatic stabilizers or, in a few cases, as a result of a deliberately anti-cyclical budgetary stance. The deficit of the general government represented, for the Community as a whole, 6,4% of GDP in 1993, a figure clearly above that of the beginning of the decade. Although more than three quarters of this deterioration can be accounted for by cyclical factors, the current situation is hardly sustainable. Decisive action is necessary to reduce budgetary imbalances in the Community, supported by an adequate policy mix leading to steady and sustained economic growth; indeed, developments during Stage I have shown that the convergence of budgetary positions to the benchmark values of the Treaty while recession persists is a very difficult task.

The deterioration of the budgetary situation has been generalized throughout the Community. In 1993, with the excep-

tion of Ireland and Luxembourg, no other Member State is expected to comply strictly with the deficit benchmark of 3% of GDP. The deterioration is most evident in Denmark, Germany, France and the United Kingdom (where the public deficits in per cent of GDP in 1993 are estimated to reach 4,4, 4,2, 5,9 and 7,6%, respectively), given the low level of earlier deficits. Except for Germany, these countries took deliberate measures to mitigate the effects of the economic slowdown. In Spain, the widening of the deficit in 1993 to 7,2% of GDP more than offset the progress achieved in the previous year; a similar development occurred in Portugal. Some other Member States aiming at fiscal consolidation either remained on a gradual upward trend or achieved a stabilization in their government deficit, e.g. Italy. In the Netherlands, the deficit was brought down after 1990 and was kept at relatively low level (4,0% of GDP in 1993), while Ireland and Luxembourg stand as the EC Member States with the lowest deficits.

Having occurred in a period of low, if not negative, real growth and of low or decelerating inflation, the widening of governments' deficits has led to a rise in the public debt to GDP ratios throughout most of the Community. This situation is particularly worrying for those Member States where the public debt to GDP ratio is clearly above the 60% benchmark; the public debt to GDP ratio is now over 100% in three Member States and has not yet been stabilized, which must first be achieved before the required steady decline.

Progress was achieved as far as convergence in long-term interest rates within the Community is concerned. Long-term interest rates have declined since 1990 and the dispersion among Member States has narrowed; all but four Member States already satisfy the interest-rate criterion of the Treaty. This trend largely reflects the favourable development of inflation and illustrates the high level of financial integration achieved in the Community.

The stability of exchange rates within the exchange rate mechanism (ERM) of the European Monetary System came under increasing pressures from mid-1992 as uncertainties were created about progress towards EMU by the delays in the ratification of the Treaty on European Union. For several of the currencies which have been realigned or for which participation in the ERM has been suspended, this was a reflection of accumulated divergences in inflation and cost performance. More generally, the continuing pressures on other currencies and the decision in early August 1993 to widen the fluctuation margins to plus or minus 15% resulted from the problems created by the high interest rates needed in Germany to cope with the effects of unification for other countries faced with recession. The cautious approach to interest-rate reductions that has been adopted since August indicates a desire to maintain a commitment within the Community to monetary cooperation based on stable exchange rates.

Although not spelled out in Article 109 of the Treaty, real convergence cannot be ignored. Achievements in this domain were disappointing given the sharp increase in the unemployment rate in the Community, from 8,3% in 1990 to 10,6% in 1993, which means a jobless total of about 17 million on average this year. In addition, the process of catching up, which made significant progress during the late 1980s, stalled with the current recession. However, supply conditions have improved in the Community through the implementation of structural reforms; in addition, the profitability of investment, which is important to cope with the challenge of unemployment, does not seem to have been damaged overmuch by the current cyclical downswing.

Progress in implementation of Community law regarding the internal market

The legislative framework for an internal market, as defined in the Commission's White Paper of 1985, is now almost fully in place. 95% of the check-list of White Paper legislation has now been adopted, and is in the process of being implemented by the EC institutions and Member States. This accomplishment is all the more impressive as the measures which require the greatest adjustment on the part of the Member States — the switch-over to the 'transitional' VAT regime, the abolition of capital controls, the freedom to provide banking and insurance services throughout the Community, a framework for the liberalization of public procurement in all sectors including the utility sectors, the liberalization of air and road transport — have all been successfully negotiated and adopted. The legislative steps which have already been taken constitute the principal elements of the internal market framework, and will be sufficient to trigger the bulk of the pro-competitive and resource allocation gains which will flow from internal market completion.

A handful of White Paper measures remain on the table, many of which would greatly facilitate the exercise of cross-border activities by economic operators. In particular, progress on proposals relating to the introduction of a Community trade mark, the alleviation of double taxation problems, and the creation of a European company statute are eagerly awaited by the business community. The Community must also look beyond the White Paper to areas where additional trade barriers have been identified. As regards the abolition of frontier controls on the free movement of persons, the recent Schengen ministerial meeting fixed 1 February 1994 as the target date for the removal of these controls. Another area for further action includes sectors where the granting of exclusive rights at national level has precluded cross-border competition. The Commission has now tabled proposals or launched discussion on possible forms of liberalization in voice telephony, energy, and postal services. Internal market completion in these sectors has progressed at varying speeds and with varying degrees of success.

On the whole, the back of the legislative work has been broken. The task of the Community is now to ensure that the legal openings stemming from this legal framework are now effectively translated into commercial opportunities. The first and most crucial stage of this process will be to ensure that internal market enabling legislation is properly transposed in all Member States. At this stage, 86% of necessary transposition measures have now been taken, and there is continual improvement on this front. Member States have been less diligent in transposing internal market legislation in the fields of company law, public procurement, and financial services, possibly because these measures entered into force at a later date and transposition was accorded a lower priority.

However, the task of making the internal market work does not stop at monitoring the rate of transposition. The Commission is currently elaborating its strategic programme for the internal market, which is designed to maximize the benefits of the internal market framework for consumers, citizens, and enterprises. This involves coherent action on a number of fronts. In particular, the Community must now devote increased attention and resources to the following themes:

(i) monitoring the quality, as well as the rate of transposition, and improving the transparency of national transposition measures;

(ii) ensuring the quality of enforcement by setting up necessary channels for administrative cooperation, and developing new instruments for monitoring enforcement;

(iii) preventing the emergence of new barriers to trade through stringent application of competition policy safeguards, and the reinforcement of early-warning systems for the detection and prevention of new regulatory or administrative trade barriers;

(iv) enforcement can also be improved by imposition of sanctions on recalcitrant Member States;

(v) empowering businesses and consumers to defend their rights within the internal market by improving access to justice, and ensuring an even interpretation and application of EC law;

(vi) ongoing monitoring and evaluation of internal market legislation and its impact with a view to upgrading its performance.

In addition, the Community must look at ways of improving the interaction between internal market measures and other Community policies which can make a contribution to the improved functioning of the single market — notably, policies to assist SMEs, standardization, conformity assessment, competition policy, environmental policy, and the common commercial policy.

Internal-market-enabling legislation, whose impact will be amplified by the strategic programme, creates a legal and administrative environment in which economic operators can develop their activities on a pan-European scale. It allows them to exploit market opportunities or tap resources in other Member States. At this stage, economic operators are beginning to witness some of the concrete benefits of a single market. For instance:

(i) Border controls and formalities on cross-border shipments of goods are now a thing of the past.

(ii) Technical harmonizing legislation which was adopted at an early stage of the internal market programme is eroding technical trade barriers in sectors such as toys, medico-surgical equipment and pressure vessels.

(iii) The removal of controls on capital movements has contributed in no small measure to the increased integration of some Member States into international capital markets. This in turn has facilitated cross-border investment and eased credit shortages in those Member States.

Although the advantages of internal market integration are beginning to filter through, it would be premature to undertake a global assessment of the internal market at this stage. For a start, much internal market legislation has yet to enter into force, or to be transposed into national legislation. Secondly, complementary actions to capitalize fully on the potential of the single market must be implemented in parallel with the legislative framework (e.g. trans-European networks, the development of European standardization, etc.). Last, but by no means least, economic operators must become acclimatized to the new legislative environment and learn how to turn legal developments into commercial opportunities. This learning process may take some time, and the current recession has reduced the scope and willingness on the part of companies to undertake adventurous cross-border expansion.

Nevertheless, there are some preliminary indications that anticipation effects unleashed by the internal market programme have been the catalyst for a revitalization of corporate strategies and a shake-up of market structures in many industrial and services sectors. Many companies have responded proactively to the emerging internal market and this has been reflected in the following trends:

(i) a surge in intra-EC foreign direct investment which has been heavily concentrated in those sectors most directly concerned by internal market liberalization;

(ii) the wave of cross-border mergers and acquisitions which has formed part of the increase in intra-EC FDI;

(iii) increased interest on the part of third-country investors in locating in the Community;

(iv) indications that the internal market has been accompanied by profound changes in the degree of market integration in banking and insurance markets;

(v) a marked evolution in the proportion of output from particular sectors which is sold on other Community markets, and an increasing share of national consumption which is met by intra-EC imports.

These trends suggest an increasing Europeanization of companies' sales strategies and increased competitive discipline on domestic incumbents in the markets concerned. The impact of the internal market on business dynamics and market structures will be examined in greater detail in the study which is to be finalized by the Commission before the end of 1996. This study will also analyse the contribution of the internal market to the realization of other Community objectives, such as economic and social cohesion and the achievement of sustainable non-inflationary growth which respects the environment.

The internal market programme is not being constructed in an economic vacuum. The current recession, which has been provoked by forces unrelated to the completion of the internal market, has overshadowed the process of adaptation to the emerging single market framework. The depressed state of EC markets obscures the potential market openings created by the internal market. In addition, many, particularly small and medium-sized, companies do not have the resources or are wary of positioning themselves in order to take advantage of opportunities which lie around the corner. However, there are reasons to believe that the restructuring and investment undertaken during the late 1980s in anticipation of the internal market have strengthened the underlying competitiveness of Community industry and services. These latent strengths will provide individual companies with a springboard once economic recovery gets under way. In addition, the internal market has acted as a brake on any temptation on the part of Member States to renationalize certain elements of economic, monetary or commercial policy. Any misguided return to 'go-it-alone' policies would have proved counter-productive for economic operators and the Member States concerned.

The recent widening of margins for exchange rate fluctuation contains some potential dangers for the operation of the single market, should these new exchange rate arrangements not be managed carefully. In particular, the increased scope for exchange rate fluctuations could disrupt the operation of capital markets, while sudden changes in relative competitiveness provoked by nominal exchange rate fluctuations could generate demands for safeguard restrictions on cross-border trade. To this extent, a return to greater exchange rate stability represents a precondition for the proper functioning of the internal market. Conversely, the internal market programme can promote structural and microeconomic convergence which is needed to sustain further progress towards economic and monetary union.

I — Progress in economic and monetary convergence

1. Introduction

The first stage of economic and monetary union (EMU) started on 1 July 1990. During this stage, the idea of economic convergence is embedded in the multilateral surveillance procedure (Council Decision 90/141/EEC of 12 March 1990 on the attainment of progressive convergence of economic policies and performance during Stage I of economic and monetary union, OJ L 78, 24.3.1990). This report is intended to fulfil the requirement of the Treaty establishing the European Community (Article 109e(2)(b)) according to which, before the beginning of Stage II of economic and monetary union on 1 January 1994,

'The Council shall, on the basis of a report from the Commission, assess the progress made with regard to economic and monetary convergence, in particular with regard to price stability and sound public finances, and the progress made with the implementation of Community law concerning the internal market'.

Chapter I of this report deals with the progress made in economic and monetary convergence. It covers aspects of nominal convergence, real convergence and convergence in supply conditions. Chapter II of the report focuses on progress with the implementation of Community law concerning the internal market.

Convergence is a wide and dynamic issue. Achieving a large degree of nominal convergence is the precondition for a smooth working of a stability-oriented monetary policy. Price stability is one of the main objectives of economic and monetary policy in the Treaty on European Union. A low inflation level is the basic target of monetary policy, while sound public finances contribute to achieving that goal. In countries where disinflation and fiscal consolidation must be achieved simultaneously, the need to avoid serious repercussions on employment will focus attention on complementary labour market policies. While achieving convergence in inflation and fiscal positions mainly depends upon the economic framework in an individual Member State, the stability of other variables, e.g. interest and exchange rates, depends also upon market perceptions of economic policies.

On the macroeconomic side, the Treaty establishing the European Community spells out nominal convergence requirements, but real convergence cannot be ignored. The Treaty lists four convergence criteria (Article 109j and a separate protocol to the Treaty) towards which the Member States[1] should make progress. Although Member States are not obliged to fulfil these criteria during the first stage of EMU, they clearly act as reference targets to which Member States should converge. This report, therefore, takes these criteria as benchmarks, recognizing that approaching these targets (rather than achieving them) is the primary task of the first stage and should be continued during the second stage.

As regards real convergence, the Treaty is less precise although an important part is devoted to strengthening economic and social cohesion, which is one of the objectives of the Union (Article B of the Treaty common provisions).

Although achieving real convergence is primarily the responsibility of the Member States, many Community policies are aimed at facilitating this process.[2] Therefore, the present report not only looks at the progress in relation to the formally stated nominal convergence criteria but also reviews the achievements in real convergence. It examines both progress in the catching-up of standards of living between Member States and divergences in unemployment.

Convergence of supply conditions is dealt with from two perspectives. The Community dimension mainly concerns the economic aspects of the implementation of the internal market. An analysis of the progress achieved in this domain is provided in Chapter II of this report; the internationalization of Member States' enterprises is visible in trade integration, mergers and acquisitions, and direct investment activities. At Member State level, structural reform to improve the supply side is a primary goal. Labour market reform, and measures to foster private investment and aiming at greater competition are major elements of such a strategy.

From an institutional point of view the Treaty states that Member States should start, if necessary, the process leading to central bank independence. The final section of Chapter I of the report reviews the progress achieved in this area.

1 Denmark and the United Kingdom have opt-out clauses concerning the move to the third stage.

2 Article 130b of the Treaty establishing the European Community states that, '... The Community shall also support the achievement of these objectives (strengthening of economic and social cohesion) by the action it takes through the Structural Funds (European Agricultural Guidance and Guarantee Fund — Guidance Section; European Social Fund; European Regional Development Fund), the European Investment Bank and the other existing financial instruments'.

2. Achievements in convergence: macroeconomic aspects

2.1. Major economic events and the current economic situation

Stage I of EMU was characterized by major economic events. The implications of German unification not only determined economic developments in that country, but also had important repercussions on the Community economy as a whole during the period under consideration. While the initial effects were favourable for Europe, the adopted policy mix triggered restrictive effects later on. Spain and the United Kingdom joined the exchange rate mechanism (ERM) in June 1989 and October 1990, respectively. Both countries were facing special challenges. In Spain the catching-up process required adequate responses in policies, while in the United Kingdom the policy assignment had to be altered as monetary policy was no longer available for short-term anti-cyclical stabilization purposes. Portugal subsequently joined the ERM in April 1992. The Danish 'No' in June 1992, the uncertainties surrounding the outcome of the French referendum, the political process of ratification in the United Kingdom and the challenging of the Treaty on European Union before the German Supreme Court delayed the ratification process.

As explained in detail in Section 2.2.5 below the exchange rate mechanism (ERM) of the European Monetary System (EMS) went through a period of marked instability from mid-1992, during which several realignments of parities took place and the United Kingdom and Italy suspended their participation in the ERM system. In August 1993 the fluctuation margins were widened markedly.

Nevertheless, during Stage I, Member States remained committed to the convergence process. Convergence programmes have been adopted by most of the Member States; so far the Council has discussed and endorsed the convergence programmes of nine Member States (by order of presentation: Italy, Portugal, Ireland, Germany, the Netherlands, Spain, Belgium, Greece and the United Kingdom), mainly devoted to achieving fiscal consolidation. Moreover, monetary policy was geared to the goal of achieving and preserving a high degree of price stability. Although progress in convergence was achieved in some areas, economic developments veiled some of the convergence results in other areas.

Indeed, the Community economy is faced with important challenges. The current deep recession has led to falling levels of output, rapidly rising unemployment and widening budget deficits. One positive element is the continuation of favourable inflation trends in most Community countries. Trends in consumer and investor confidence, although no longer falling, do not suggest a significant recovery in the short term. Therefore, during the last two years, the unfavourable economic climate has been hampering visible achievements in convergence, and this may well continue through 1994.

The environment within which economic policies were conducted has become more difficult during Stage I of EMU. While the overall monetary stance within the Community has remained relatively tight given the extent of the slowdown in economic activity, fiscal policy has responded by either letting the automatic stabilizers work or even — in some countries — by discretionary fiscal loosening. It appears that fiscal policy has had to play the bigger role in accommodating the recession. Countries which entered the period of economic slowdown with still high budget deficits were faced with even greater difficulties in pursuing consolidation. Since 1992, high headline inflation rates and strong monetary growth in Germany have implied a strategy of caution in interest rate policy, while the economic fundamentals of the other countries would have suggested a more aggressive easing in domestic monetary conditions. The recurrent tensions on the foreign exchange markets were due both to unsound nominal exchange rate fundamentals in some countries and to inconsistencies within the policy mix adopted during a severe recession by other countries.

In this climate of unbalanced policy mixes, recession and rising unemployment certain structural weaknesses within the Community have become more evident and results in terms of convergence have been mixed. While inflation has declined almost everywhere in the Community, particularly in those countries whose inflation rates have been most divergent, budgetary outturns have worsened significantly.

2.2. Nominal convergence: achievements and challenges

2.2.1. Inflation

In the Community, it is now recognized that a low rate of inflation is the prerequisite for sound medium-term growth as it contributes to an efficient allocation of resources. Moreover, in the perspective of constructing EMU, convergence in inflation rates of the Member States is needed in order to avoid losses in competitiveness if exchange rates are moving towards a fixed regime. Substantial price differentials, in the tradable goods sector implying a 'competitiveness gap' between Member States, would either create higher regional unemployment — as cross-border labour mobility remains comparatively low in Europe — or require a painful downward wage and price adjustment. However, within a monetary union, some differences in inflation rates can exist without detrimental effects. Assuming that the inflation rates of the three best-performing countries are close to each other, the Maastricht inflation criterion (see below) envisages inflation differences comparable to those broadly prevailing in existing monetary unions (1 to 2%).

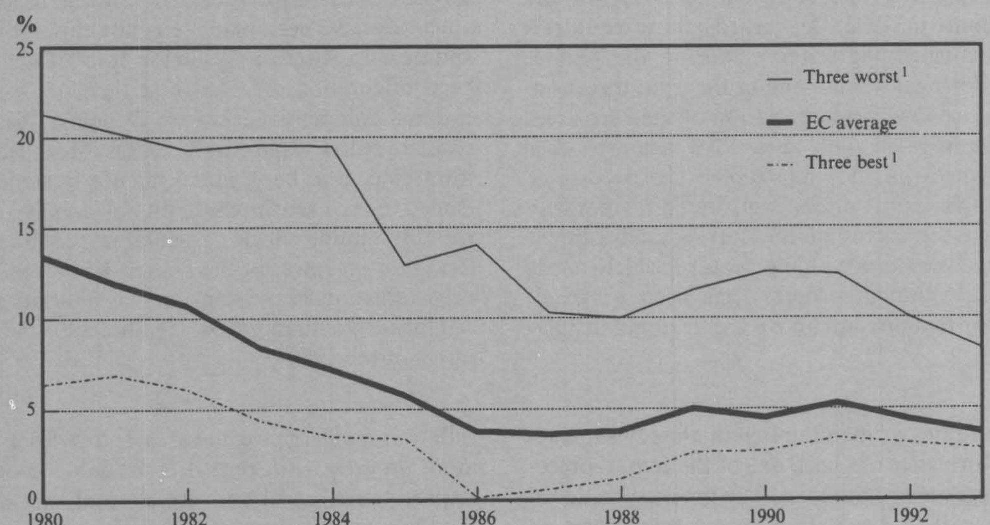
A considerable improvement in convergence among Member States was one of the encouraging features of economic developments in the Community during the second half of the 1980s. In particular, there was considerable progress in convergence of inflation rates towards a low level. Graph 1 shows that the average rate of inflation declined from above 12% in the early 1980s to slightly above 3% in 1986, a year influenced by the fall in oil prices. There was then a modest acceleration until 1991 but inflation has abated again in the last two years. Moreover, the dispersion between the high inflation countries and the low inflation countries has been declining considerably.

The Treaty establishing the European Community contains a definition of the convergence requirements regarding inflation for Stage III of EMU.[1] In recent years, a number of Member States have had an impressive performance in terms of low inflation. As shown in Table 1, seven Member States were below the upper value of the reference range in 1993.

There is a remarkable regularity in those countries which experienced a low rate of inflation during the period under review. Belgium, Denmark, Ireland, France, Luxembourg and the Netherlands have been within the range throughout the first stage of EMU. Germany's somewhat poorer performance since 1992 is mainly due to the special circumstances of unification. The United Kingdom which was well

[1] Price convergence is defined in the Treaty establishing the European Community in relative rather than absolute terms. It shall mean that a Member State has a price performance that is sustainable and an average rate of inflation, observed over a period of one year before moving to Stage III, that does not exceed by more than 1,5 percentage points that of, at most, the three best-performing Member States (Article 109j(1) and Article 1 of the Protocol on the convergence criteria referred to in Article 109j).
The Treaty requires convergence in the consumer price index (CPI) on a comparable basis taking account of differences in national definitions. In order to ensure comparability the analysis here is made in terms of the national accounts deflator of private consumption.

GRAPH 1: **Inflation, 1980-93**



[1] Unweighted average of the three worst- or best-performing countries.
Source: Commission services, economic forecast (autumn 1993).

Table 1

Inflation performance of Member States, 1990-93

	Inflation (deflator of private consumption) % change p.a.				Consumer price index: % change over 12 months
	1990	1991	1992	1993	
B	3,1	2,9[1]	2,4[1]	2,8	2,7 (October)
DK	2,6[1]	2,5[1]	1,9[1]	1,4[1]	1,2 (September)
WD[2]	2,8	3,8	4,0	3,6	3,9 (October)
D[2]	—	—	4,7	4,3	—
GR	19,7	18,4	14,9	13,7	12,3 (October)
E	6,4	6,2	6,4	4,7	4,3 (September)
F	2,9	3,0	2,4[1]	2,3[1]	2,3 (September)
IRL	1,6[1]	2,3[1]	2,6	2,3	1,4 (Q3[3])
I	5,2	6,9	5,4	4,4	4,3 (October)
L	3,6	2,9	2,8	3,6	3,5 (October)
NL	2,2[1]	3,4	3,0	2,1[1]	1,9 (October)
P	12,6[1]	11,1	9,7	6,7	6,0 (September)
UK	5,3	7,2	4,7	3,4	1,8 (September[3])
EUR–[2]	4,5	5,3	4,4	3,7	3,4 (September)
EUR+[2]	—	—	4,6	3,8	—
Reference range	3,1 to 4,1	3,8 to 4,4	3,4 to 3,9	2,9 to 3,8	

[1] The three best-performing Member States in inflation; the reference range has been calculated by assuming that either the best-performing country or the third best-performing country determines the reference range.
[2] WD = West Germany, D = unified Germany. EUR– = EUR 12 including West Germany, EUR+ = EUR 12 including unified Germany.
[3] Excluding the housing component the figures are: 2,2%, (IRL) and 3,6% (UK).
Source: Commission services, economic forecast (autumn 1993).

above the reference range in 1991, especially, has since seen a slowing in the inflation rate sufficient to be below the upper reference limit in 1993. As regards those countries which have not satisfied the criterion during the period, Spain, Italy and Portugal are moving in the right direction. It appears that up to now the depreciation of the currencies of these four countries in 1992 and 1993 against other Community currencies has not interrupted the process of disinflation although import prices contributed temporarily to inflation. Given the extent of the currency adjustment involved, this is a very encouraging feature which needs to be maintained. Although progress has been achieved, inflation in Greece remains far above the Community average.

Reducing inflation rates or maintaining an already satisfactory inflation performance has been one of the central objectives of the convergence programmes. The progress achieved has so far been broadly in line with the indicative targets set in the programmes although in Germany headline inflation is coming down more slowly than projected. Some of the programmes have placed considerable emphasis on the need to reform wage-setting procedures and other aspects of the labour market and to increase competition in product and services markets in order to restrain inflation, and some advances have been made (e.g. abolition of wage indexation and new wage-setting system in Italy). Other countries have been orientating their wage settlements toward improving external competitiveness (e.g. Denmark, France) through a strategy of low wage cost increases. More recently the moves towards central bank independence in some countries have tended to increase the credibility of stability-oriented policies with favourable effects on actual wage settlements and long-term interest rates. In the United Kingdom, the impact of a deep recession in reducing the core inflation rate has been significantly enhanced by the successful labour market reforms of the 1980s.

Inflation convergence towards a low level has made even more progress with regard to tradable goods and services. Export prices have been very flat and below 2% on average for the Community as a whole during the 1990-93 period. The greater competition already achieved in these sectors has contributed to price discipline. Similar developments can be expected if competition is increased in other sectors through the realization of the single market, in particular in services like transportation, insurance and financial services. In some Member States, e.g. in the catching-up countries, structural changes may to a certain extent explain relatively high inflation. While high productivity growth in manufacturing is maintaining competitiveness in the tradable sectors, relatively high wage increases have had spill-over effects on non-tradables where productivity growth was lower, leading to a relatively high domestic-basket inflation rate.

While the effects of stronger competition and structural changes are difficult to measure, a more traditional analysis of factors which have contributed to inflation during the 1990-93 period suggests a favourable impact from import prices in the early part of the period. In addition to their direct price-stabilizing impact (see Box 1) import prices reduced input costs at the producer level which prevented profit margins from falling more significantly in the tradable sector. In the period 1992-93 the effects of import prices were less uniform. It appears that those countries which continued to belong to the ERM core were able to import price stability while those countries which devalued in 1992 and 1993 were experiencing an upward contribution of import prices to inflation. However, there are hopes that these will prove to be once-for-all effects.

After a fairly high contribution of unit labour costs to inflation in some countries (Greece, Spain, Italy, Portugal and the United Kingdom) in 1990, almost all countries are now experiencing a lower contribution from this source. Lower nominal wage increases due to the recession but also the attempts of many countries to improve productivity through structural reform are the main elements behind this feature, which is encouraging as far as inflation prospects beyond 1993 are concerned.

Increases in indirect taxes played a relatively important role as a determinant of headline inflation in a number of countries in the early 1990s. In Germany higher indirect taxes were one important means to cope with the fiscal challenges of unification, while other Member States increased indirect taxes to make progress in fiscal consolidation.

Box 1: Contributions to inflation

This box provides a mechanical assessment of the factors which have contributed to the change of the deflator of final uses (the national accounts index measuring the prices of final domestic demand and exports in aggregate). The table disentangles the domestic components into unit labour costs, net indirect taxes and the gross operating surplus. As regards the latter, an increase in profit margins would be indicated by a high contribution of the gross operating surplus. The table does not provide information about causalities. For example, profit margins might rise because of either a decline in other contributing factors, e.g. lower unit labour costs, or demand-induced inflation enabling enterprises to increase prices. Moreover, only the direct impact of import prices is considered while lower import prices for material inputs are reflected in a larger gross operating surplus.

A direct link to the implicit deflator of private consumption or the consumer price index (CPI) cannot be easily made. For example, the effects of indirect taxes on the private consumption deflator might be larger as various demand components (investment, exports) are exempted from various indirect taxes.

The data do not necessarily add up as it is mechanically impossible to differentiate between volume and price effects as far as the contribution of import prices is concerned. Therefore, information about the determinants of inflation can only be taken as a crude guide to the transmission mechanisms of inflation.

Table 2

Contribution to the change in the final uses deflator[1]

(Percentage points per year)

	Import prices				Nominal unit labour costs				Net indirect taxes				Gross operating surplus			
	1990	1991	1992	1993	1990	1991	1992	1993	1990	1991	1992	1993	1990	1991	1992	1993
B	−0,5	−0,1	−0,5	1,3	1,9	1,8	1,8	1,8	0,1	0,0	0,5	0,2	−0,4	−0,2	0,2	−0,3
DK	−0,4	0,3	−0,3	0,3	0,5	0,7	0,9	0,7	−0,2	0,1	−0,3	0,5	1,7	1,1	0,9	−0,4
WD[2]	−0,1	0,4	−0,3	−0,1	1,0	1,9	2,2	1,7	0,3	0,8	0,6	0,6	1,2	0,4	0,6	0,4
D[2]	—	—	−0,3	−0,1	—	—	—	—	—	—	0,8	0,5	—	—	—	—
GR	2,3	4,7	2,2	3,5	12,2	6,5	6,7	6,3	3,1	2,9	2,0	2,0	0,3	5,3	2,2	1,7
E	−0,2	−0,1	0,2	1,8	4,2	3,1	3,9	1,9	0,3	0,4	1,0	−0,7	1,6	2,2	0,4	2,0
F	−0,3	0,0	−0,4	−0,4	1,7	1,8	0,9	1,3	0,4	0,0	−0,1	0,2	0,3	0,6	1,0	0,8
IRL	−1,5	0,9	−0,4	1,9	−0,1	0,8	0,5	1,6	−1,5	−0,1	0,6	−0,2	0,5	−0,1	−0,4	0,4
I	0,1	0,0	0,3	1,9	5,2	4,5	2,1	1,0	1,1	1,0	0,4	0,3	0,1	0,7	1,4	2,0
L	0,0	0,6	−0,7	1,4	2,7	2,0	1,7	2,3	0,1	0,5	0,3	0,2	−1,3	−1,0	0,3	−0,9
NL	−0,4	0,0	−0,6	0,0	0,6	1,5	1,6	1,2	0,3	0,1	0,7	−0,1	0,6	0,3	−0,6	0,0
P	2,0	0,4	−0,9	1,4	6,0	6,5	5,5	2,8	1,3	1,1	1,9	−0,4	2,4	2,1	2,2	2,6
UK	0,5	−0,4	0,0	1,8	4,8	4,1	2,2	0,1	−0,6	1,1	0,4	0,2	0,6	0,1	1,0	2,0

[1] The table contains mechanical calculations of the various factors contributing to final demand deflators. As regards the consumer price deflator the effects of indirect taxes might be larger as various demand components are exempted from VAT, for example.

[2] WD = West Germany, D = unified Germany.

Source: Commission services, economic forecast (autumn 1993).

2.2.2. Public finances

While the average government deficit[1] in the Community was almost halved during the 1980s (from above 5% of GDP in 1981 to less than 3% in 1989), the government deficit soared to more than 6% in 1993. Although some of this increase is due to cyclical factors, the speed of deterioration is very worrying indeed.

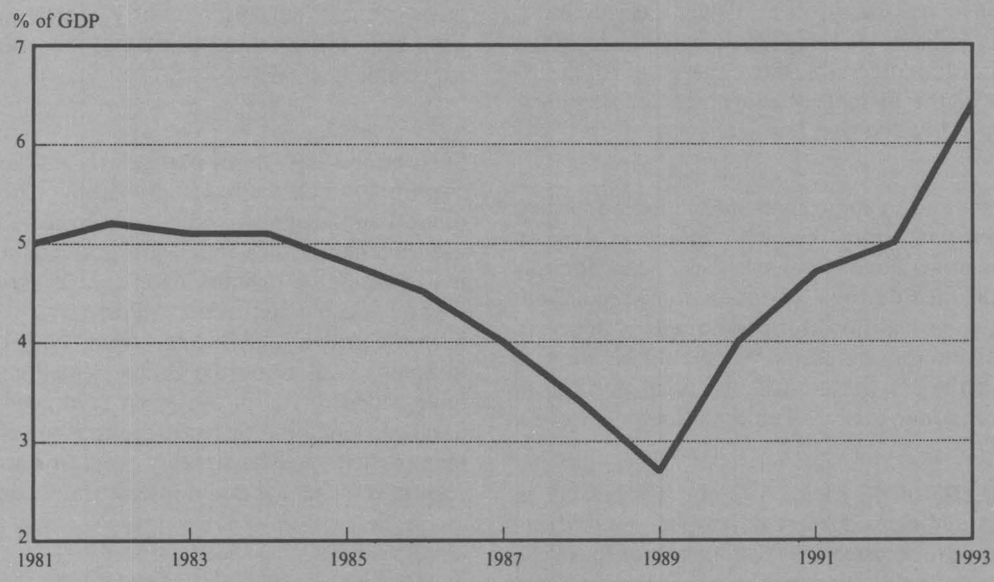
This rapid deterioration in the Community position is reflected in the performance of individual countries. Latest estimates for 1993 indicate that all Member States, except Greece, Italy and the Netherlands, will have higher deficits this year than in 1990. This trend in deterioration is more especially evident in Denmark, Germany, France and the United Kingdom, given the low level of earlier deficits. Except for Germany, these countries took deliberate fiscal measures to mitigate the effects of the economic slow-down. In Spain, the widening of the deficit in 1993 more than offset the progress achieved in the previous year; a similar development occurred in Portugal, where, however, fiscal consolidation is more pressing. Some other Member States aiming at fiscal consolidation either remained at a gradual upward trend (Belgium) or achieved a stabilization in their government deficit, e.g. Italy, despite the more unfavourable economic environment. In the Netherlands the deficit was brought down after 1990 and was kept at a relatively low level, while Ireland and Luxembourg stand as the Community members where the deficit is the lowest.

In 1993 only Ireland and Luxembourg would comply strictly with the Treaty's general government deficit reference value of 3% of GDP, while in the early 1990s Denmark, Germany, France and the United Kingdom also had budget deficits below 3% of GDP.[2] In these countries, the expected deterio-

[1] The definition used in this report for the government deficit (net borrowing of general government) largely conforms with the definition in the Treaty establishing the European Community (Article 104c of the Treaty and Article 2 of the Protocol on the excessive deficit procedure). Full conformity with the Treaty requires complete harmonization of concepts which will be completed on the basis of the forthcoming secondary legislation.

[2] The criteria of the government financial position is defined in the Treaty establishing the European Community in absolute terms (Article 104c(2) and Article 2 of the Protocol on the excessive deficit procedure). The ratio of the planned or actual government deficit to gross domestic product should not exceed a reference value of 3% of GDP, unless either the ratio has declined substantially and continuously and reached a level that comes close to the reference value; or, alternatively, the excess over the reference value is only exceptional and temporary and the ratio remains close to the reference value.
The level of gross government debt must not exceed 60% of GDP or must be sufficiently diminishing and approaching the reference value at a satisfactory pace.

GRAPH 2: **Net borrowing of general government in the Community, 1981-93**



Source: Commission services, economic forecast (autumn 1993).

ration in the public finance situation from the previous year is evident. While in Germany the combined effects of unification and the deepening recession are reflected in the public finances, Denmark and France have sought to reduce the effects of recession by a pro-active fiscal policy, an approach similar to that followed by the United Kingdom in 1992.

Establishing sound and sustainable public finances is a central goal of all the convergence programmes; all of them set medium-term targets for deficit reduction, generally aiming to respect the 3% of GDP deficit target by 1996 (see Box 2) and to stabilize the debt ratio and then put it on a declining trend. So far there has been a significant shortfall in achieving the fiscal targets of the programmes (except for the United Kingdom whose convergence programme was presented relatively recently). For the most part these shortfalls are not due to an absence of adjustment effort; most of the governments have introduced successive budgetary adjustment packages at least on the scale of those initially envisaged as necessary. Instead, budgetary plans have been blown off-course by the unexpected growth slow-down, and in some cases by higher interest rates in 1992.

The pre-1993 convergence programmes were, in general, far too optimistic about growth prospects. By 1994 the level of

Table 3

General government net borrowing of Member States, 1990-93

(% of GDP)

	1990	1991	1992	1993
B	5,8	6,6	6,9	7,4
DK	1,5	2,2	2,6	4,4
WD[1]	2,1	3,5	2,3	3,8
D[1]	—	3,2	2,6	4,2
GR	18,6	16,3	13,2	15,5
E	3,9	5,2	4,6	7,2
F	1,5	2,1	3,9	5,9
IRL	2,2	2,0	2,2	3,0
I	10,9	10,2	9,5	10,0
L	−3,3	1,0	2,5	2,5
NL	5,1	2,5	3,5	4,0
P	5,5	6,4	5,2	8,9[2]
UK	1,2	2,7	5,9	7,6
EUR −[1]	4,0	4,7	5,0	6,4
EUR +[1]	—	4,6	5,0	6,4
Reference value	3,0	3,0	3,0	3,0

[1] WD = West Germany, D = unified Germany, EUR− = EUR 12 including West Germany, EUR+ = EUR 12 including unified Germany.
[2] Latest budget estimates point to a figure of 8,3% of GDP.
Source: Commission services, economic forecast (autumn 1993).

GDP in Germany and Spain is likely to be about 8 to 9% lower than projected in those countries' convergence programmes, and cumulative shortfalls of over 6% are probable for Belgium, Italy and Portugal. These much weaker growth paths have inevitably meant lower tax revenues, rising expenditure shares and higher deficits through the working of the automatic stabilizers. These shortfalls increase the scale of the budgetary adjustment effort which has to be undertaken in the next few years.

A need for further and in some cases intensified budgetary consolidation exists in almost every Community Member State. Appropriate measures to achieve fiscal consolidation are better implemented during a period of sound economic growth. During a cyclical downturn the question arises as to what extent the automatic stabilizers should be allowed to work. Indeed, the deterioration in the fiscal position is also due to the economic cycle as Table 5 shows.

Analysing the impact of the cycle on the budget balance is useful for understanding budgetary developments, particularly during periods of recession, but estimation of the cyclical component is subject to some uncertainties and the figures in the final column of Table 5 should be interpreted as broad orders of magnitude rather than precise estimates.

That a large part of the worsening in budget deficits has been induced by the recession should not be a reason for complacency. The distinction between actual and cyclically adjusted deficits is made difficult by the fact that some cyclical factors could become structural (mainly through hysteresis phenomena in the labour market, i.e. a downward rigidity in the unemployment rate) and that growing interest-rate payments tend to increase the consolidation needs in terms of non-interest expenditure.

The developments in primary balances (i.e. budgetary balances excluding interest payments) provide evidence on the determination of governments to reduce their deficits. Most Member States with large budgetary disequilibria actually have primary surpluses, clearly indicating that measures have been taken to consolidate in those areas where room for manoeuvre exists.

Such efforts have been particularly marked in Italy where the primary balance has improved by 3,3 percentage points of GDP in the period 1990-93. In Greece, the primary deficit has been significantly reduced. Although the primary surplus is decreasing, it remains significant in Belgium, Denmark, Ireland and the Netherlands. Portugal too has been able to keep the primary balance in surplus until 1992. Conversely, in Spain, France and the United Kingdom primary deficits have widened. All in all, given continued commitment to fiscal consolidation there are grounds to believe that government deficits will be sizeably reduced once the current recession is overcome and if interest rates continue to fall.

Nevertheless, in general the primary surpluses have not been enough to reduce or stabilize the government debt level (see below). In particular the combination of a high level of government debt and high interest rates has led to increasing interest payments, which exceed 10% of GDP in a number of countries. Even some countries with a relatively moderate debt level are now confronted by an historically high level of interest payments (Denmark, Portugal and to a lesser extent Spain and the Netherlands).

Although government debt levels and thus the interest burden have in the long run mainly to be reduced by operating on the primary surplus, the need to achieve sustainable

Box 2: The public finance block of the convergence programmes

The table presented opposite allows a comparison between the targets of the convergence programmes with the performance realized in 1992 and 1993.

A comparison has to take into account that the convergence programmes have been submitted in a very different economic situation. In particular, the underlying assumptions of the convergence programmes have proved to be much too optimistic in view of the actual economic developments. Economic growth had to be revised downwards generally and real interest rates were higher than assumed in some cases. Nevertheless, the convergence programmes show the clear commitment of Member States to achieve medium-term consolidation.

Table 4

Comparison of convergence programme (CP) projections of budget deficit and outturns for 1992 and 1993

(% of GDP)

Country	General government net borrowing (unless otherwise stated)					
	Date[1]	1992	1993	1994	1995	1996
Belgium						
CP	6/92	5,7	5,2	4,5	3,8	3,0
CP revised	4/93	:	5,8	4,7	3,6	3,0
Outturn	11/93	6,9	7,4	:	:	:
Germany						
CP[2]	10/91	4,25	4,0	3,0	:	:
Outturn[2]	6/93	3,8	5,25	:	:	:
Outturn	11/93	2,6	4,2	:	:	:
Greece						
CP	2/93	9,4	8,6	7,0	4,4	1,6[3]
Outturn	11/93	13,2	15,5	:	:	:
Spain						
CP	4/92	4,0	3,5	2,7	1,8	1,0
Outturn	11/93	4,6	7,2	:	:	:
Ireland						
CP	10/91	:	:	:	:	:
Outturn	11/93	2,2	3,0	:	:	:
Italy						
CP[4]	10/91	8,4	6,7	5,5	:	:
CP revised[4]	9/92	10,2	9,3	7,3	4,7	:
Outturn[4]	11/93	10,8	9,9	:	:	:
Outturn	11/93	9,5	10,0	:	:	:
Netherlands						
CP	4/92	3,5	2,9	2,4	:	:
Outturn	11/93	3,5	4,0	:	:	:
Portugal						
CP	10/91	4,0[5]	3,0[6]	3,0[6]	3,0[6]	:
Outturn	11/93	5,2	8,9	:	:	:
United Kingdom						
CP[7]	5/93	7,75	8,75	7,50	5,50	4,75[8]
Outturn	11/93	5,9	7,6	:	:	:

1 Date when the convergence programme (or its revision) was submitted, and of latest Commission services estimate for the outturn (autumn 1993).
2 Public authorities financial deficit.
3 The deficit is projected to decline to 0,8% of GDP in 1997 and 0,2% in 1998.
4 State sector borrowing requirement.
5 In the budget for 1992 and 1993 the official targets were set at 5,2% and 4,2% of GDP, respectively, which was claimed to be compatible, on an annualized basis, with the targets of the convergence programme for these years.
6 Average deficit in the three years 1993 to 1995.
7 Financial years ending in March of the following calendar year.
8 The deficit is projected to decline to 4% of GDP in the 1997-98 financial year.

Table 5

Cumulative changes of the general government deficits, 1990-93[1]

	General government deficit in % of GDP, 1993	Cumulative change 1990-93, in % of GDP	
		Change in actual deficit	Change in cyclical component
B	7,4	1,6	2,7
DK	4,4	2,9	1,6
WD[2]	3,8	1,7	1,4
D[2]	4,2	—	—
GR	15,5	−3,1	0,4
E	7,2	3,3	2,7
F	5,9	4,4	2,2
IRL	3,0	0,8	1,7
I	10,0	−0,9	1,8
L	2,5	5,8	2,7
NL	4,0	−1,1	2,2
P	8,9	3,4	2,2
UK	7,6	6,4	3,3
EUR−[2]	6,4	2,4	2,2
EUR+[2]	6,4	—	—

[1] The approach to calculate the cyclically adjusted deficit consists of taking into account a reference path for GDP calculated by estimating a mean trend for GDP over the cycles. The change in the cyclical component measures the budgetary impact of changes in the output gap relative to trend and interest payments on public debt are not taken into account in the cyclical component.
[2] WD = West Germany, D = unified Germany. EUR− = EUR 12 including West Germany, EUR+ = EUR 12 including unified Germany.
Source: Commission services, economic forecast (autumn 1993).

Table 6

Primary balance of Member States for 1990-93

(% of GDP)

	Primary balance[1]				Interest payments 1993
	1990	1991	1992	1993	
B	5,2	3,9	4,3	3,7	11,1
DK	5,8	5,1	4,2	3,1	7,5
WD[2]	0,6	−0,7	0,8	−0,6	3,2
D[2]	—	−0,5	0,7	−0,8	3,5
GR	−6,7	−3,5	0,4	−0,5	15,0
E	−0,4	−1,2	−0,4	−2,2	5,0
F	1,4	1,0	−0,5	−2,2	3,7
IRL	5,7	5,6	4,9	4,2	7,3
I	−1,3	0,0	1,9	2,0	12,0
L	3,9	−0,4	−1,9	−1,7	0,8
NL	0,9	3,6	2,7	2,3	6,3
P	2,7	2,0	3,8	−1,3	7,6
UK	2,2	0,3	−3,0	−4,5	3,1
EUR−[2]	0,8	0,4	0,4	−0,8	5,6
EUR+[2]	—	0,4	0,4	−0,9	5,6

[1] General government balance excluding interest payments (surplus +, deficit −).
[2] WD = West Germany, D = unified Germany. EUR− = EUR 12 including West Germany, EUR+ = EUR 12 including unified Germany.
Source: Commission services, economic forecast (autumn 1993).

budgetary positions through significant primary surpluses is an economically, socially and politically difficult challenge. A high primary surplus could worsen the structure of expenditure, in particular if public investment is reduced, or could create social strains and lead to unwarranted income distribution effects. In any case, the need for a high primary surplus to ensure debt sustainability implies a greater vulnerability in the public finances to domestic and external shocks. Reducing the interest burden through lowering the stock of debt and lower long-term interest rates are also important for successfully achieving medium-term fiscal consolidation.

The developments in government debt levels mainly reflect past behaviour of public finances, real growth, and inflation. Five Member States (Germany, Spain, France, Luxembourg and the United Kingdom) have had a gross government debt-to-GDP ratio below 60% throughout Stage I. However, in all of these countries the debt ratio is now deteriorating. Ireland and Portugal made considerable progress in reducing their debt ratio until 1992. Denmark has reduced its debt ratio considerably in the 1980s, but a rising trend emerged in the 1990s. In Belgium, Greece and Italy the government debt to GDP ratio debt is again rising fast and stands at a very high level (above 100% of GDP).

Gross general government debt figures presented in Table 7 are not yet in most cases in full accordance with the definitional requirements laid down in Article 2 of the Protocol on the excessive deficit procedure annexed to the Treaty on European Union, nor with the detailed definition of debt laid down in the forthcoming Council Regulation on the application of the provisions of the abovementioned Protocol.

For Table 7, the Commission services chose among the gross debt series available in the Member States the definition which they view as the closest to the Treaty definition. Therefore the figures in Table 7 are only indicative and cannot be formally retained as benchmarks for comparison with the reference value of the Treaty's criterion on public debt.[1]

[1] With the coming into force of the second stage towards EMU on 1 January 1994, Member States will produce government debt data which meet the detailed definition of the Council Regulation and will report them to the Commission with specific information, like the financing of public enterprises through issuance of government debt.

Table 7

Gross general government debt of Member States, 1990-93

(% of GDP)

	1990	1991	1992	1993
B	128,3	129,5	131,9	138,4
DK	66,4	71,7	73,4	78,5
WD[1]	43,7	—	—	—
D[1]	—	41,9	44,7	50,2
GR	95,3	100,9	106,7	113,6
E	44,5	45,5	48,8	55,6
F	35,4	35,5	39,2	44,9
IRL	96,1	95,9	91,6	92,9
I	97,8	101,4	108,0	115,8
L	7,0	6,2	7,3	10,0
NL	78,8	79,0	79,7	83,1
P	68,4	67,4	63,5	69,5
UK	39,6	41,0	47,3	53,2
EUR–[1]	57,2	—	—	—
EUR+[1]	—	58,0	61,7	66,4
Reference value	60,0	60,0	60,0	60,0

NB: *Belgium:* Consolidated central and local government debt; social security debt not included.
Denmark: Central government short-term liabilities not included; general government not consolidated.
Germany: Gross consolidated general government debt at nominal value.
Greece: General government not consolidated; central bank's direct advances not included.
Spain: General government not consolidated.
France: Gross consolidated general government debt, excluding trade credits and accounts payable and receivable, at nominal value.
Ireland: Central government (exchequer).
Italy: Gross consolidated general government debt at nominal value.
Luxembourg: Social security debt not included; general government debt not consolidated.
Netherlands: Gross consolidated general government debt at nominal value.
Portugal: Central government and certain autonomous funds; debt of social security and local authorities not included.
United Kingdom: Valuation of debt at market prices.

[1] WD = West Germany, D = unified Germany, EUR– = EUR 12 including West Germany, EUR+ = EUR 12 including unified Germany.

Source: Commission services, economic forecast (autumn 1993).

2.2.3. Balance of current account

Although different in nature from the explicit convergence variables dealt with in the Treaty, current account developments remain important indicators of the economic performance of a country. However, in integrating economies like in the European Community the interpretation of current account developments is becoming more difficult, in particular the financing aspects of current account imbalances lose most of their significance in the presence of fully liberalized capital movements. Rather than aiming at current account equilibrium as a target of economic policy the issue is the appropriateness of the external position within the overall economic performance of a particular economy.

In any individual Member State, the balance on the current account reflects conditions in the real economy. If unemployment is relatively high or productivity is relatively low, policies to improve the productive potential of the economy could be associated with the emergence of a current account deficit, as capital flows in from abroad to take up profitable investment opportunities. In such a case, the deficit would be a positive development as imported capital is used to temporarily alleviate the constraint imposed on the level of domestic investment by the level of national savings. As the activity level in the domestic economy increases, the deficit would be expected to be self-correcting.

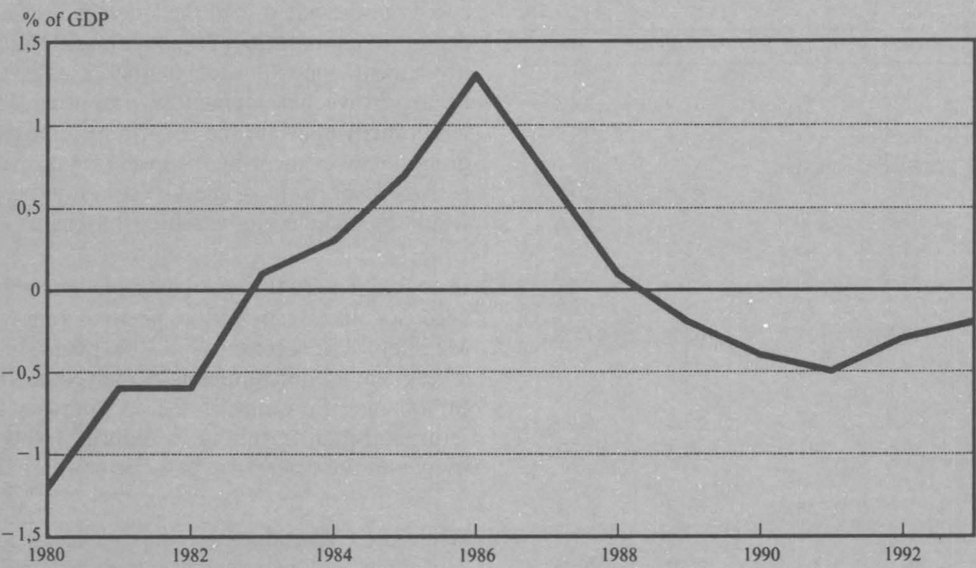
In a similar vein, the emergence of a current account surplus need not necessarily reflect positive supply conditions in a Member State economy. If the profitability of domestic investment opportunities is perceived to be relatively low, capital may flow out of the economy in search of higher returns abroad, resulting in reduced levels of domestic activity and the emergence of a current account surplus.

While these considerations have increased in their importance now that progress has been achieved in liberalizing capital movements, traditional factors explaining current account trends still remain important too. Important changes in competitiveness at both the world level and between Community Member States have influenced trade flows and the public sector has been (partly) offsetting the saving-investment behaviour of the private sector by an anticyclical behaviour.

The current account balance of the Community was in deficit in the aftermath of the second oil price shock. However, the deficit of around 1% of GDP in 1980 was transformed into a surplus of above 1% of GDP in 1986. There were both external and domestic reasons for such a turnaround. As regards the external environment, the policy choice taken by the USA, which stimulated Community exports via a depreciation against the dollar, the fall in oil prices and the relatively high growth abroad must be singled out. Domestically, demand was subdued in the Community, mainly because of the efforts to consolidate public finances (e.g. in Germany) and the need to improve financial conditions in the private sector (e.g. in France at the enterprise level).

The year 1986 marked a turning point in current account at the Community level. Starting in the United Kingdom and Denmark (1984) investment activities improved substantially in Spain and France in 1985/86, followed by all other Member States until the end of the decade. The decline in the current account surplus was thus a reflection of private sector optimism and of a high rate of growth and job creation and therefore no reason of concern. The swing in private

GRAPH 3: **Balance of current transactions in the Community, 1980-93**



Source: Commission services, economic forecast (autumn 1993).

sector saving was even greater than reflected in the current account balance as the net borrowing of general government narrowed substantially (by more than 2% of GDP) in that period.

Although current account developments are not uniform across Member States during the period 1990 to 1993, some common features can be identified. A rising current account surplus emerged in those countries where domestic demand was particularly depressed and unemployment rising, e.g. Belgium, Denmark, France and Ireland. Nevertheless, until 1992 competitiveness was improving gradually in these countries due to the positive development of domestic costs. The relatively large current account deficits prevailing in Spain, Portugal and the United Kingdom were partly due to the real appreciation of their currencies during the phase of economic upswing; in these countries the current account deficit was also reduced temporarily because of depressed private sector demand. More recently some of those Member States which depreciated substantially relative to other Community countries show some reduction in the current account deficit (Spain, Italy).

The most significant change in the current account balance has occurred in Germany as a consequence of unification.

Table 8

Balance on current transactions of Member States, 1990-93

(% of GDP)

	1990	1991	1992	1993
B	0,9	1,7	1,8	1,3
DK	0,5	1,4	3,0	2,8
WD[1]	3,6	1,4	1,6	0,4
D[1]	–	−0,6	−1,3	−1,2
GR	−6,1	−5,1	−4,4	−3,7
E	−3,7	−3,8	−3,7	−2,7
F	−0,9	−0,5	0,2	0,6
IRL	−0,7	2,0	3,6	3,4[2]
I	−1,4	−1,8	−2,1	0,1
L	34,3	28,0	27,5	25,2
NL	3,8	3,6	3,2	3,0
P[3]	−2,5	−2,9	−2,1	−2,1
UK	−4,2	−1,8	−2,3	−2,9
EUR−[1]	−0,4	−0,5	−0,3	−0,2
EUR+[1]	—	−1,1	−1,1	−0,4

[1] WD = West Germany, D = unified Germany, EUR− = EUR 12 including West Germany, EUR+ = EUR 12 including unified Germany.
[2] In national accounts definition the figure for 1993 is equivalent to 5,1% of GDP.
[3] Break in the series 1991-92 — up to 1991: national accounts figures; from 1992 onwards: balance of payments.

Source: Commission services, economic forecast (autumn 1993).

The large drop observed in the aftermath of unification was a reflection of the large gap between demand and supply in Germany at that time. While the East German production potential became largely obsolete, reducing supply, demand was stimulated by large transfers and rapid wage increases. However, the persistence of a current account deficit of around 1% of GDP during the recent recession is no longer explainable only by the shock of unification. The deterioration in competitiveness and continued weak foreign demand are becoming more dominant factors.

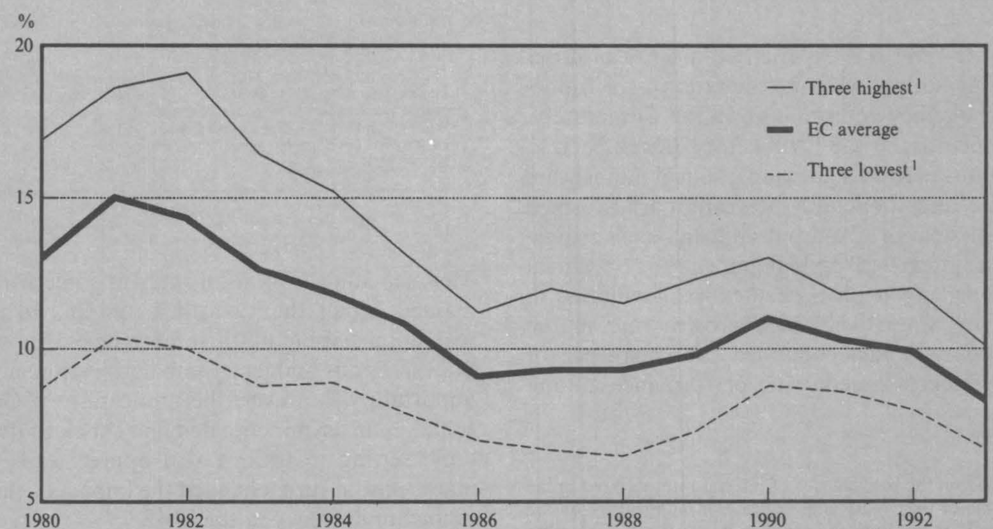
All in all, current account developments during the 1990s highlight some less positive developments. Firstly, current account deficits went hand in hand with a substantial decline in investment activities throughout the Community and, more recently, also of private consumption. Secondly, while private sector saving is increasing, deficits in the public sector are growing rapidly. Thirdly, competitiveness of the Community economy appears to be much less promising than was the case in the second half of the 1980s. The present current account situation of the Community as a whole may thus be an indicator of low growth prospects and further rising unemployment. The need for policies geared to improve competitiveness, in particular through structural reform, is evident.

2.2.4. Long-term interest rates

In line with progress in reducing inflation, the Community average long-term interest rate fell from an exceptionally high level of 15% in 1981 to about 9% in 1988. A tightening of monetary policy, coupled with financial markets' unease at inflationary prospects in post-unification Germany and temporary fears of a world capital shortage, resulted in a reversal of this favourable trend in 1988. Since 1990, however, there has been another general easing in long-term interest rates so that the Community average is currently about 8%, which mainly reflects a decline in inflation expectations.

The trend in long-term interest rates has been characterized by a general decline in levels across the Community and a significant convergence among Member States. Convergence in long-term interest rates has been due mainly to a successful disinflation process in several Member States and illustrates the high degree of financial integration achieved in the Community as a result of the single market programme. Convergence is being achieved at a relatively low level of long rates reflecting moderate inflationary expectations to which the prospect of a period of slow growth is also contributing.

GRAPH 4: **Long-term interest rates, 1980-93**



[1] Unweighted average of the three countries with the highest or lowest rates; Greece and Portugal excluded because of missing data.
Source: Commission services, economic forecast (autumn 1993).

Assessment of convergence in long-term interest rates in the precise terms of the Treaty requirements[1] is currently hampered by the lack of homogeneity in the reported interest rates as displayed in Table 9. Interest rates on benchmark 10-year government bonds are also included in the table; however, in some Member States the market for these bonds is still very thin or virtually non-existent. With this caveat in mind, the table shows, based on the long-term interest rate in the three best-performing Member States in terms of inflation in 1993 (Denmark, France and the Netherlands) a reference range of 8,7 to 10,9%. Most other countries have long rates below the upper limit of the reference range.

The evolution in long-term interest rates has become less predictable as the ERM framework, which had contributed to a convergence in long rates, has been weakened (see next section). While the widened fluctuation margins persist exchange-rate discipline will no longer be assured by a known tight mechanism so that financial markets will determine the level and trend in longer-term interest rates by more direct reference to the counter-inflationary credibility of the policy mix (reflecting the inter-relationship between the inflation and public finance criteria) in each Member State.

The emergence of risk premiums on long rates will only be avoided if Member States remain credibly committed to the achievement of nominal convergence and pursue monetary and fiscal policies consistent with these objectives.

Table 9

Interest rate performance of Member States, 1990-93

	Long-term interest rate[1]				Benchmark 10-year government bonds (September 1993)
	1990	1991	1992	1993	
B	10,1	9,3[2]	8,6[2]	7,3	7,1
DK	11,0[2]	10,1[2]	10,1[2]	8,9[2]	6,8[2]
WD[3]	8,9	8,6	8,0	6,3	6,1
D[3]	—	8,6	8,0	6,3	6,1
GR	:	:	:	:	:
E	14,7	12,4	12,2	10,2	9,1
F	9,9	9,0	8,6[2]	6,8[2]	6,1[2]
IRL	10,1[2]	9,2[2]	9,1	7,7	:
I	13,4	13,0	13,7	11,3	9,5
L	8,6	8,2	7,9	6,9	:
NL	9,0[2]	8,9	8,1	6,72	6,0[2]
P	16,8	17,1	15,0	12,4	10,0
UK	11,1	9,9	9,1	7,9	6,9
EUR –[3]	11,0	10,3	9,9	8,1	—
EUR +[3]	—	10,2	9,9	8,1	—
Reference range	11,0 to 13,0	11,2 to 12,1	10,6 to 12,1	8,7 to 10,9	

1 A comparison between countries is not easily possible as the respective definitions are different:
B: Central government bonds (over 5 years — secondary market).
DK: State and mortgage bonds.
D: Public sector bonds outstanding (monthly averages).
GR: Central government bonds.
E: Central government bonds at 2 years and over (since January 1988).
F: Central government bonds: 7 to 10 years.
IRL: Central government bonds: 15 years.
I: Public sector bonds outstanding (since January 1992).
NL: Yield of 5 State bonds with the longest maturity (monthly average) (since January 1985).
P: Bonds over 5 years (weighted average of public and private).
UK: 20-year bonds (end-of-month).
EUR: Average of 12 countries using GDP weights.

2 The three best-performing Member States in inflation are used to calculate the reference range by assuming that of these three, the countries with the lowest and highest long-term interest rates determine the reference range.

3 WD = West Germany, D = unified Germany. EUR – = EUR 12 including West Germany, EUR + = EUR 12 including unified Germany.

Source: Commission services, economic forecast (autumn 1993).

2.2.5. Exchange-rate stability in the ERM

Since mid-1992, the EMS has experienced a series of crises which has fundamentally altered its operation as a framework for monetary-policy coordination in the Community. The source of difficulties in the EMS can be traced back to the late 1980s. In this period, a growing political momentum towards economic and monetary integration transformed the EMS from a system of 'fixed but adjustable' exchange-rate parities into a system with no realignments. The political commitment to unchanged EMS parities was facilitated in economic terms by a relatively high growth rate in the Community economy, which concealed the emergence of a cumulative divergence in economic performance among Member States. Inflation rates in some Member States remained higher than in others, leading to an accumulated real appreciation of their currencies. In several Member States, serious budgetary imbalances were not tackled. Most importantly, however, the unification of Germany had resulted in an asymmetric demand shock to its domestic economy, setting in train a real appreciation of the German mark; this, in turn, changed the impact of the German mark as anchor currency in the EMS.

Initially, the Community had benefited from the increased export growth associated with higher German demand but strains began to emerge from mid-1991 when the Bundes-

1 The reference value on the convergence of interest rates referred in the Treaty (Article 109j of the Treaty and Article 4 of the Protocol on the convergence criteria) means that the criterion is satisfied if a Member State has had an average nominal long-term interest rate that does not exceed by more than 2 percentage points that of, at most, the three best performing Member States in terms of price stability. Interest rates shall be measured on the basis of long-term government bonds or comparable securities, taking into account differences in national definitions.

bank gradually tightened monetary policy in response to an acceleration in the German inflation rate. As the German mark — the anchor currency — strengthened in response to tighter monetary conditions, the commitment to fixed exchange rates within the ERM forced other Member States to pursue a monetary policy which was too strict in relation to conditions in their domestic economy.

By this time, the demand boom of the late 1980s had petered out and economic activity was already slowing down across the Community. As economic conditions became more difficult, the consequence of the divergent economic performance among Member States was thrown into sharp relief. With growth already slipping below trend and, in some cases, budgetary imbalances deteriorating rapidly, financial markets began to question the ability of Member States to sustain the costs of maintaining exchange-rate stability through the pursuit of the tight monetary stance necessitated by inflationary pressures in Germany. The appreciation of the German mark (and hence other ERM currencies) *vis-à-vis* the dollar as a consequence of widening short-term interest-rate differentials further added to the difficulties of many Member States.

In a period in which welcome progress was being made in the liberalization of capital movements, the increasing inconsistency between political aspirations to fixed exchange rates and underlying economic realities was potentially highly destabilizing. Free capital movement within the Community was an integral element of the single market programme and by 1990-91 most Community countries had already eliminated controls on cross-border capital movements. Liberalized capital movements together with deregulation and innovation in financial markets (not only in the Community but in most industrialized countries), led to remarkable globalization of portfolio investments during the last decade. The increase in cross-border holdings, coupled with factors such as (i) technological advances in dissemination of information (ii) the introduction of new derivatives, (iii) increased institutionalization of savings and (iv) concentration of investment decisions in the hands of professional managers, has created the potential for huge and volatile capital flows between currencies if investors lose confidence in any given exchange rate. The efficiency of foreign exchange markets has undoubtedly been enhanced by capital liberalization but market participants have become much more powerful *vis-à-vis* central banks than was the case during the early years of the ERM.

In the context of liberalized capital markets, the mix of unchanged nominal exchange rates, inadequate economic convergence and difference in cyclical economic position set the scene for exchange-rate instability if economic policies underlying ERM parities are not seen to be consistent. Inconsistencies clearly existed but were ignored by financial markets so long as the EMU project — implying economic discipline on aspirant participants to ultimately validate their unchanged ERM parities by appropriate policy adjustments — remained unquestioned. Indeed, the pre-crisis period was characterized by capital inflows into high-yielding currencies, such as the lira, sterling, peseta and escudo in so-called 'convergence plays' using these currencies as profitable proxies for the German mark. However, financial market fears in the face of these inconsistencies emerged strongly following the Danish rejection of the Maastricht Treaty on 2 June 1992 and the uncertainty created by the French decision to hold a referendum on the Treaty in September. These events caused a major correction in the financial markets' expectations on EMU. In consequence, the markets began to question the wisdom of their portfolio positions in high-yielding currencies: the so-called 'convergence plays' began to unwind as institutions sought to protect themselves against newly perceived devaluation risks.

The ensuing period of 18 months was characterized by repeated bouts of market pressure on ERM currencies as huge amounts of capital flowed between currencies, primarily into the German mark. The severity of pressure resulted in a sequence of adjustments within the ERM, involving the withdrawal of two currencies from the system, five realignments involving four currencies and ultimately in early August 1993 the temporary widening of fluctuation margins to plus or minus 15%.

The widening of ERM bands implies a major change of regime in monetary cooperation in the Community. A system of quasi-fixed exchange rates has been temporarily replaced by a system allowing, in principle, greater flexibility in exchange-rate movements within wide bands. The weakening of exchange-rate discipline within the ERM represents a setback to the integration process within the Community as previously envisaged but, in the present circumstances, wider ERM bands are the most pragmatic response to the recurrent tensions on the foreign-exchange markets. The EMS remains in existence in a modified form, while speculative pressure on the ERM grid has been significantly eased. Despite the potential for differentiated monetary policies within the modified EMS, there has been no dramatic adjustment in the monetary stance in Member States since the beginning of August. The cautious approach to interest-rate reductions that has been adopted reflects a desire to maintain a commitment within the Community to monetary cooperation based on stable exchange rates. In consequence, exchange-rate movements within the ERM have been rather limited.

Any effort to re-establish narrow bands without improved economic convergence among Member States would almost certainly not be accepted by the financial markets and would incite renewed speculative attacks on the ERM grid. The experience of the recent crises has demonstrated that a necessary condition for exchange-rate stability is achieved by the pursuit of credible and consistent economic policies designed to foster economic convergence in conditions of economic growth, while focusing on the fundamentals of price stability and sound public finances.

2.3. Real convergence

2.3.1. Introduction

As regards real convergence this report distinguishes three aspects: (i) catching up in real income, i.e. the narrowing of differences in standards of living, (ii) unemployment performances and, finally, (iii) convergence in general supply performances.

The catching-up process made significant progress during the 1980s. Average income grew faster than the EC average in Spain, Ireland and Portugal, but not in Greece. However, the current recession is limiting the possibility of fast rising per capita income in the countries concerned. Nevertheless, as long as competitiveness is kept under control, these countries should be able to achieve a higher growth trend relative to Community partner countries.

The Community is still faced by large differences in unemployment levels. This not only concerns differences between Member States but also unacceptably large discrepancies existing within individual countries (e.g. in Germany, Greece, Spain and Italy). Reducing these differences is important in finding a socially acceptable balance as integration proceeds. Otherwise regional challenges will grow. Creating new jobs through investment is an essential means to reduce unemployment.

Following the liberalization of capital movements investment is now likely to take place in those areas where the expected rate of return is highest. Creating improved supply conditions through structural reform and establishing favourable and durable expectations for a competitive real rate of return are decisive to cope with the challenge of unemployment. The successful implementation of the internal market is contributing to the improvement of supply conditions within the Community. During the 1980s there has been an improving trend in profit margins. Even more encouraging is that in the current recession the deterioration in profitability has been relatively modest compared with earlier cyclical downswings.

2.3.2. Catching up in real income

The achievement of real convergence is a central goal of Community policies. Just as with nominal convergence, achieving real convergence is the responsibility of each Member State. However Community policies, e.g. the structural Funds and the Cohesion Fund, contribute importantly to this process.

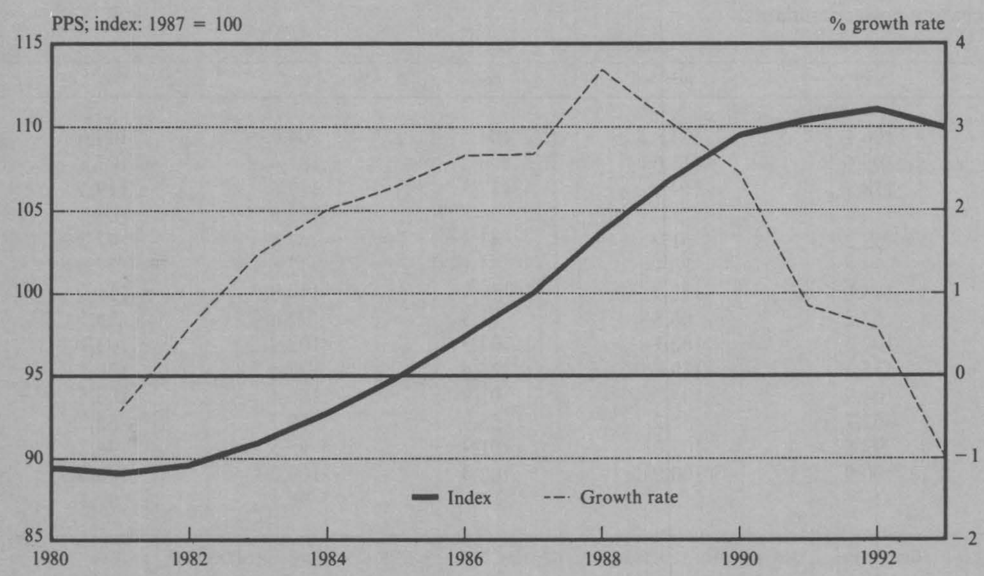
In a strict sense real convergence means the narrowing in the differences in standards of living across regions. As the mobility of labour is expected to remain limited during the European integration process, it is equally important that large differences in unemployment between countries are avoided.

During the 1980s the conditions for a successful catching-up process in the Community improved. Greater integration improved the scope for division of labour so that each country could exploit more successfully its comparative advantages. The liberalization of capital movements further enhanced the conditions for catching up as it alleviated the external constraint on financing investment. In the presence of favourable opportunities, both foreign and domestic investment have taken place on a large scale. In addition, greater macroeconomic stability contributed to attracting foreign investments to the catching-up Member States, e.g. Spain, Ireland and Portugal.

Nevertheless, catching-up does not depend only upon economic conditions in the country in question. In general, catching-up is facilitated in an environment of favourable growth in the Community as a whole or even worldwide. Since investment is the cyclically most volatile demand component, catching-up Member States might be most hit by recession as investment is cut back. Low demand might increase fears of over-capacity and initial expectations of a high rate of return might be reduced, increasing pessimism about economic prospects. Moreover, recession enhances the risk of slower economic integration if countries try to protect domestic sectors.

During the 1980s the standard of living in the European Community increased remarkably. Real GDP per head was around 25% higher at the end of the decade compared with 1980. After modest growth at the beginning of the decade, the growth rate accelerated to 3% per year on average in the second half of the decade. The average growth rate in the Community (2,3%) during the 1980s was only marginally below that of the USA (2,5%) but considerably below the growth rate in Japan (4,2%).

GRAPH 5: **Real GDP per head of population in the Community, 1980-93**



Source: Commission services, economic forecast (autumn 1993).

Table 10 shows that there are still wide differences between Member States as far as GDP per head is concerned, measured in terms of purchasing power standards.[1] While a group of richer countries exceeds the Community average by about 10% (Denmark, France, Luxembourg), Greece only reaches 48% of the average income level. However, there has been an important boost to catching up in Spain and Portugal since their accession to the Community in 1986. While in these countries GDP per head was only 70% and 51% of the Community average in 1985 respectively, in 1993 they stand at 78% and 62%. Ireland also went through a similarly successful catching-up process, narrowing the gap in income level from the Community average by more than 10 percentage points in the last decade. In contrast, Greece has fallen back by 3 percentage points over this period.

As regards the richer countries, France (in the second half of the 1980s) and the United Kingdom (in the first half of the 1980s) have improved their relative position in the Community, while Denmark (in the second half of the 1980s) and the Netherlands (over the whole period) have experienced a relative decline. Luxembourg was able to extend its top position, meanwhile Belgium and Italy remained slightly above the Community average. The relative position of Germany is strongly affected by unification. While the standard of living in West Germany was second highest in 1990, unified Germany is in fourth position, with an average income level only slightly higher than the Community average.

2.3.3. Unemployment

Reducing unemployment was a big challenge among European countries during the last decade. Graph 6 shows that unemployment in the Community rose steadily from 6% in 1980 to a peak level of 10,8% in 1985. During the second half of the 1980s unemployment fell, approximately to the level of 1982. All Member States made considerable progress in creating jobs in the second half of the 1980s. Employment growth even exceeded 3% per year for a few years in a row, e.g. in Spain in 1987-90, Luxembourg in 1988-91, the United Kingdom in 1988-89 and to a somewhat lesser extent in

[1] The purchasing power standard (PPS) allows a comparison of GDP per head because it takes into account the price level in each Member State and excludes short-term exchange-rate fluctuations.

Table 10

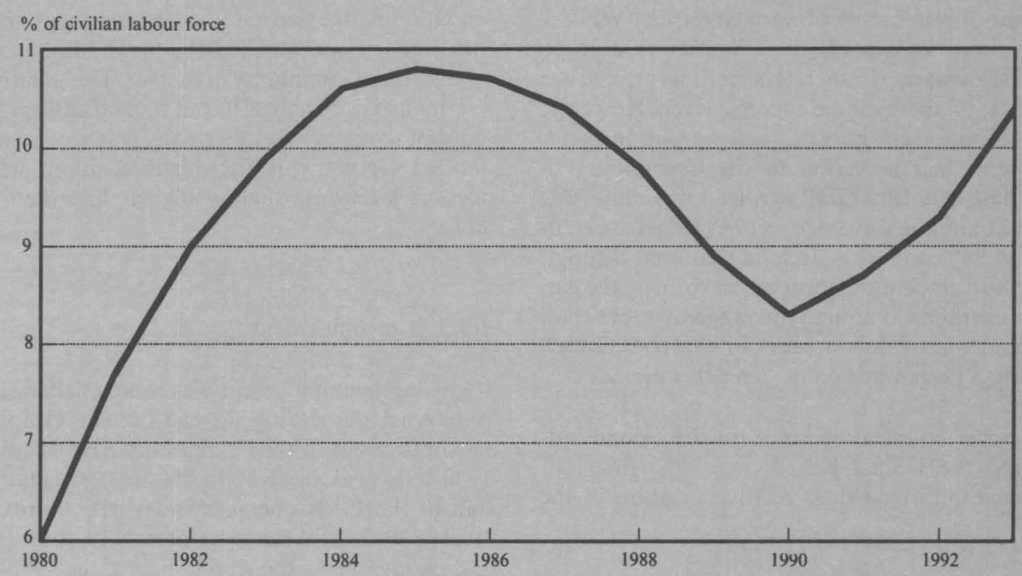
GDP per head of population in Member States
(According to purchasing power standards)

(Index: EUR– = 100)

	1980	1985	1990	1991	1992	1993
B	106,1	103,9	104,4	104,9	104,6	103,7
DK	105,6	113,6	106,2	107,4	107,8	108,6
WD[1]	118,7	119,1	117,3	119,8	119,5	117,0
D[1]	—	—	—	102,6	104,2	104,1
GR	52,2	51,0	47,3	47,4	47,3	47,5
E	71,6	70,1	75,1	77,6	77,6	77,6
F	113,6	112,5	110,7	110,8	111,0	110,6
IRL	62,2	63,8	71,3	72,6	75,1	77,0
I	102,3	102,1	102,3	102,9	103,1	103,6
L	115,3	119,8	126,6	127,5	128,7	129,8
NL	108,9	105,3	101,9	100,4	100,5	100,5
P	52,7	51,2	55,9	58,7	62,0	62,3
UK	97,5	101,0	101,3	95,5	94,2	96,7
EUR–[1]	100,0	100,0	100,0	100,0	100,0	100,0
EUR+[1]	—	—	—	96,9	97,3	97,8

[1] WD = West Germany, D = unified Germany, EUR– = EUR 12 including West Germany, EUR+ = EUR 12 including unified Germany.
Source: Commission services, economic forecast (autumn 1993).

GRAPH 6: **Unemployment rate in the Community, 1980-93**



Source: Commission services, economic forecast (autumn 1993).

Table 11

Unemployment rates of Member States[1]

(% of civilian labour force)

	1980	1985	1990	1991	1992	1993
B	7,4	11,8	7,6	7,5	8,2	9,5
DK	5,2	7,2	8,1	8,9	9,5	10,5
WD[2]	2,7	7,1	4,8	4,2	4,5	5,6
D[2]	—	—	—	5,1	5,9	6,8
GR	2,7	7,7	7,0	7,7	7,7	7,8
E	11,6	21,6	16,1	16,3	18,0	21,2
F	6,2	10,1	9,0	9,5	10,0	10,8
IRL	8,0	18,2	14,5	16,2	17,8	18,4
I	7,1	9,9	10,0	10,0	10,3	11,0
L	2,4	2,9	1,7	1,6	1,9	2,6
NL	6,4	10,5	7,5	7,0	6,7	8,2
P	7,6	8,8	4,6	4,1	4,7	5,2
UK	5,6	11,4	7,0	8,8	10,0	10,4
EUR−[2]	6,0	10,8	8,3	8,7	9,3	10,4
EUR+[2]	—	—	—	8,8	9,5	10,6

[1] Eurostat definition.
[2] WD = West Germany, D = unified Germany, EUR− = EUR 12 including West Germany, EUR+ = EUR 12 including unified Germany.
Source: Commission services, economic forecast (autumn 1993).

West Germany after unification. For the Community as a whole employment grew by about 1,5% in the high-growth years 1987-89. Employment growth was, however, relatively low or even negative in Denmark, Greece, Ireland and Portugal during the second half of the 1980s.

Although still higher than in the trough of the early 1980s, employment is now falling by more than $1\frac{1}{2}$% per year. Indeed, the early 1990s are witnessing a renewed and very significant deterioration in the labour market situation. Within three years (1991-93) the unemployment rate has risen by 3 percentage points, back to the peak level of the mid-1980s.

Although the levels of unemployment were very different, almost all Member States witnessed a similar profile in unemployment with a peak in 1985 and a declining trend thereafter. Some countries (Belgium, the Netherlands, Portugal and the United Kingdom) achieved lower rates of unemployment at the end of the decade than at the beginning while unemployment was higher in Germany, Spain and France. Italy's unemployment rate was on a rising but contained trend over the last decade and was characterized by weaker cyclical fluctuations than most of the other Member States. Unemployment rates are extraordinarily high in Spain and Ireland.

Table 11 illustrates that large differences in rates of unemployment are prevailing at the beginning of the 1990s. Unemployment rates in 1993 are around 7 to 8% in Germany (unified), Greece, and the Netherlands but about 20% in Spain and Ireland. Belgium, Denmark, France, Italy and the United Kingdom have unemployment rates of between 9 and 11%. In Portugal the unemployment rate has been increasing from 4,1% (1991) to 5,2% (1993).

2.4. Convergence in supply performance

2.4.1. Convergence of supply conditions matters

European economic integration, in particular when the internal market has been put in place, should go together with a high degree of convergence in supply performance between Community Member States. The coexistence of liberalized capital movements and continued limitations on mobility within the European labour market makes convergence in supply conditions even more important.

Differences in supply conditions among Member States, globally measured by the expected rate of return on physical capital, will influence private sector investment decisions. A region (country) in which the (expected) marginal real rate of return on capital is inferior to that of other regions would suffer. Investment and, therefore, job creation would take place elsewhere and the result would be regional unemployment.

As investment decisions depend upon expectations (i.e. what really matters is the expected real rate of return), it is important to establish a high degree of microeconomic credibility, i.e. markets should be flexible enough to sustain a sufficient real rate of return. A lack of supply-side credibility in a given Member State would result in a microeconomic risk premium, which would require a real rate of return superior to that of other countries. The credibility of any microeconomic regime depends upon various factors among which the operation of the labour market, commitment to market openness and competition, the taxation system and infrastructural conditions are most important.

A detailed analysis of all these aspects is beyond the scope of this report. However, the link between macroeconomic performance and the supply side is obvious. Structural reforms at the Member State level aimed at improving the functioning of markets and supported by the implementation of the internal market programme are a crucial element in this context. Market participants will have greater concerns about the sustainability of macroeconomic and exchange-rate commitments if they doubt the ability of economies to respond flexibly to the type of disturbances that are likely to occur.

On a macroeconomic level, wages, real unit labour costs and investment profitability are the important determinants of the supply-side performance of a country, while microeconomic flexibility is difficult to measure empirically.

Wage developments have a pivotal role to play not only in the process of convergence and in sustaining macroeconomic stability but also in revitalizing an employment-creating growth trend in the Community at the present time. A certain degree of wage moderation has been experienced recently but continued moderation is warranted given the high and rising rate of unemployment.

An effective response to the latter problem necessitates a rise in the investment ratio in order to increase the Community's growth potential. A rise in investment is dependent on actions in a number of areas including measures to improve investment profitability. The latter can be ameliorated through an appropriate evolution of real unit labour costs which, in turn, is an amalgam of real wage and productivity developments.

Over the period 1982-89 a strong adjustment took place in the overall macroeconomic evolution of wages in relation to productivity which contributed strongly to the improvement in the general environment for investment, employment and growth. Annual rates of growth in real compensation per employee, while still remaining positive, grew at moderate rates in relation to productivity. This pattern of real incomes growing at rates lower than that of productivity was consequently reflected in a continuous decline in real unit labour costs (RULCs) (see Box 3) over the period.

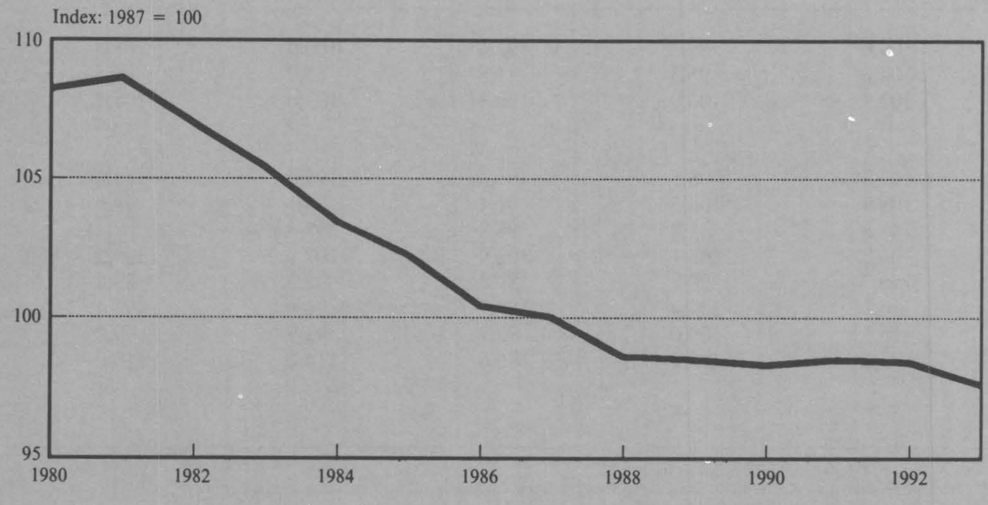
The decline in RULCs was the single most important factor in boosting the profitability of capital (i.e. the rate of return on fixed capital) which rose steadily in the 1980s from the low point reached in 1981 of less than 70% of the average of the quasi full-employment period 1961-73 to over 90% in 1990. In addition to the decline in RULCs, the improvement in profitability was assisted by a slight improvement in capital productivity which emanated essentially from a strong rise in capacity utilization.

The overall improvement in profitability more than compensated for the higher real long-term interest rates prevailing in the 1980s, compared with the previous decade, and provided the basis for an upturn in gross fixed capital formation which underpinned a durable and strong recovery in output and employment over the period.

A comparative analysis reveals that the decline in RULCs, and consequent improvement in profit margins occurred in almost all countries (Table 12). It was most pronounced in the catching-up countries Spain, Ireland and Portugal, but Belgium, West Germany, France and the Netherlands also improved their profitability more than other countries up to 1989. Italy and in particular the United Kingdom have not succeeded in improving their profit margins to the same extent as partner countries.

This favourable assessment does not hold entirely if manufacturing industry is looked at alone. Although the underlying data is somewhat less reliable, it seems clear that in manufacturing the improvement in profitability is much less evident. Although in Denmark, France, and the Netherlands profitability has improved markedly since the mid-1980s, some other countries have experienced quite a significant deterioration, e.g. Belgium, West Germany, Spain and the United Kingdom. In Spain, Italy, and the United Kingdom output prices were squeezed by competition in tradables up to 1992. Thereafter, devaluation together with no significant acceleration in domestic labour costs has helped to restore profitability in industry in these countries.

GRAPH 7: **Real unit labour costs in the Community, 1980-93[1] — Total economy**



[1] Real unit labour costs (i.e. the share of labour income in national income) are used as a proxy for profitability; PPS weighted.
Source: Commission services, economic forecast (autumn 1993).

Table 12

Real unit labour costs of Member States[1] — Total economy

(Index: 1987 = 100)

	1980	1985	1990	1991	1992	1993
B	107,2	102,0	96,5	98,5	98,8	100,5
DK	106,1	97,6	96,8	95,9	95,8	96,2
WD[2]	104,7	100,0	95,9	95,9	96,1	96,2
D[2]	—	—	—	—	—	—
GR	97,2	107,6	102,8	95,7	94,0	92,8
E	113,7	103,0	98,0	97,2	98,2	98,0
F	107,5	104,3	96,8	97,5	97,1	96,9
IRL	113,4	102,2	97,5	98,5	98,5	99,4
I	103,4	103,1	100,3	101,0	100,1	98,1
L	105,7	96,7	99,4	102,0	102,2	105,2
NL	109,1	96,5	94,8	95,6	97,0	98,2
P	114,5	104,7	94,1	95,5	94,8	94,4
UK	105,3	100,7	105,4	106,6	106,4	103,6
EUR–[2, 3]	107,7	102,0	98,3	98,5	98,4	97,6
EUR+[2, 3]	—	—	—	—	—	—

[1] Nominal unit labour costs deflated by the GDP price deflator.
[2] WD = West Germany, D = unified Germany, EUR– = EUR 12 including West Germany, EUR+ = EUR 12 including unified Germany.
[3] PPS weighted.
Source: Commission services, economic forecast (autumn 1993).

Table 13

Real unit labour costs performance of Member States[1] — Manufacturing industry

(Index: 1987 = 100)

	1980	1985	1990	1991	1992	1993
B	109,6	99,3	92,4	100,9	103,8	103,8
DK	104,8	95,3	85,5	85,9	84,4	82,7
WD[2]	103,9	100,0	100,3	103,6	107,5	110,5
D[2]	—	—	:	:	:	:
GR	:	:	:	:	:	:
E	112,2	96,5	106,3	109,7	114,9	110,4
F	108,9	106,5	91,4	94,1	94,0	96,4
IRL	141,8	111,8	98,3	98,3	:	:
I	104,0	103,1	102,9	107,7	109,5	106,4
L	116,7	90,7	89,0	92,0	89,6	90,6
NL	116,1	101,4	88,7	91,0	93,4	94,6
P	115,3	100,0	93,7	93,9	99,2	100,5
UK	113,1	103,2	106,6	114,0	110,0	110,1
EUR−[2]	:	:	:	:	:	:
EUR+[2]	—	—	:	:	:	:

[1] 1992-93: estimates for B, DK, WD, E, F, I, L, NL. 1991-93: estimates for P, UK.
[2] WD = West Germany, D = unified Germany, EUR− = EUR 12 including West Germany, EUR+ = EUR 12 including unified Germany.
Source: Commission services, economic forecast (autumn 1993).

Box 3: Global assessment of capital profitability

1. Measuring macroeconomic profitability

From a macroeconomic point of view, the profitability of fixed capital is equal to the profit rate per unit of GDP (the unit profit rate) times the average productivity of capital (the inverse of the capital/output ratio). The unit profit rate is measured by the ratio of the net operating surplus to the value-added at factor cost for the whole economy (or its manufacturing sector). Since the net operating surplus is defined as net domestic product (or value-added) at factor cost minus the total wage cost of employees, the unit profit rate — the profit share — is thus the counterpart of the share of labour in value-added, which is also referred to by the term real unit labour cost.

The average (apparent) productivity of capital is the ratio of the value-added to the net stock of capital, but the decomposition can be pushed further by breaking down this ratio into the product of the average (apparent) productivity of labour times the inverse of capital intensity.

(1) Profitability = net operating surplus/capital stock
= net operating surplus/value-added × value-added/capital stock

(2) Productivity of capital = value-added/capital stock
= value-added/employment × employment/capital stock

All these constituent elements are published in the national accounts statistics except for the capital stock which can however be approximated with these statistics by cumulating the difference between gross investment flows and depreciation flows. (For more details on the methodological aspects, see *European Economy* No 50, Study No 2, December 1991.)

2. Interpreting profitability and its main components

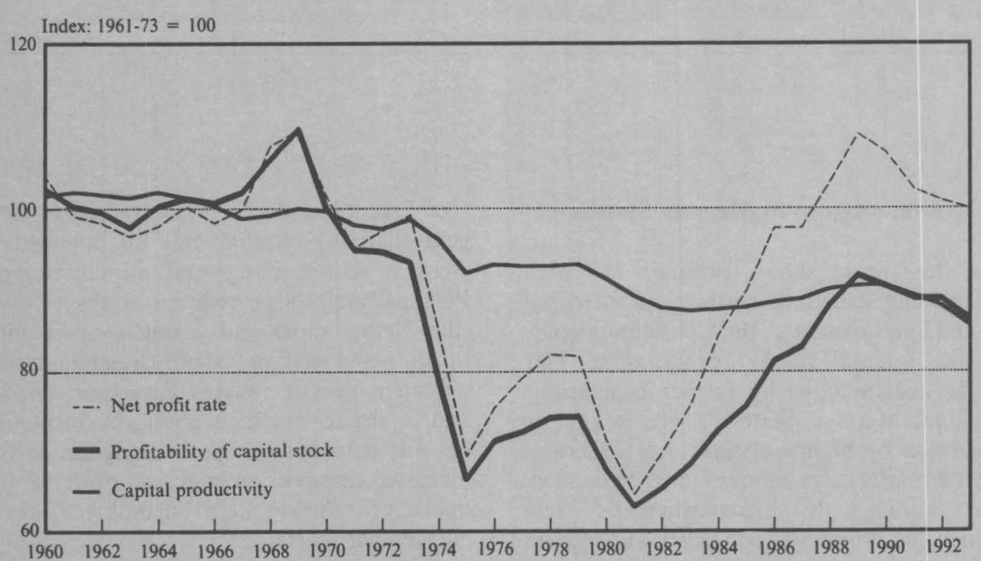
Wage moderation, i.e. a rate of growth of real wage compensation lower than the rate of growth of labour productivity, means a decrease in real unit labour costs, or an improvement in the profit share. While the profit share in value-added (or its counterpart, the labour share) appears to be the main determinant of profitability, and is often used as its crude proxy, it is clear from the definition and formulas given above that the capital/output ratio also plays an important role in the variation of capital profitability: any increase in the capital/output ratio, i.e. any decrease of the apparent capital productivity, does affect negatively the profitability of capital. Thus to take but a small sample of stylized cases, profitability will not improve:

(i) if the increase in the profit share due to wage moderation goes together with a similar increase in the capital/output ratio (a fall in capital productivity); such an increase in the capital/output ratio could result from a fall in labour productivity or an increase in the capital intensity of the production process;

(ii) if, profit shares being stable, an increase in labour productivity comes only via an increase in capital intensity.

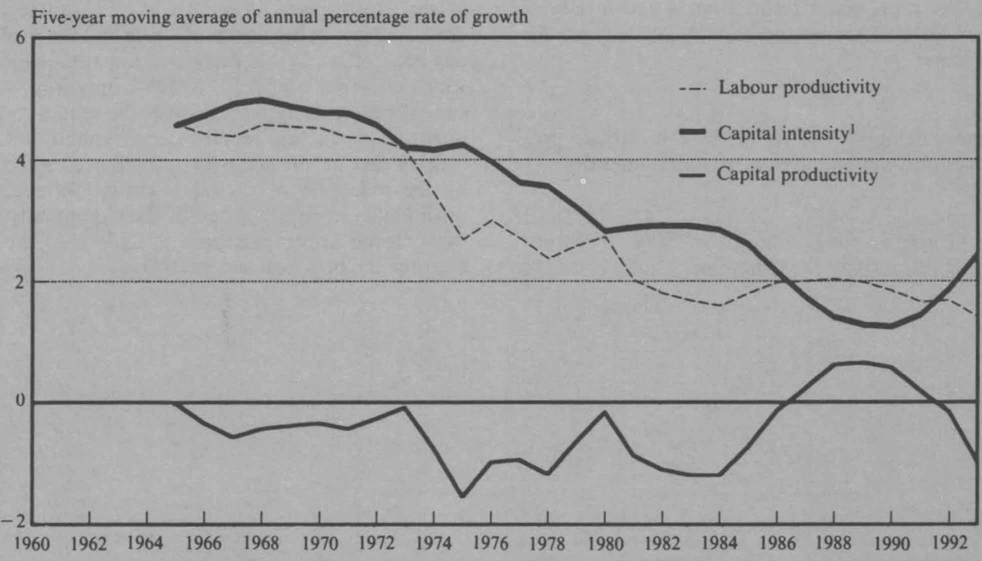
For example, as Graph 8 shows, during the 1980s, the profit shares improved significantly in the Community, mainly due to wage moderation, making up for the losses registered in the second half of the 1970s, and even exceeding the average level of 1961-73. However, a significant part of this improvement in the profit share — shown by the gap registered between developments in the unit profit rate and the profitability rate — has been offset by the decline in apparent capital productivity which occurred from 1970 to 1984: only from 1985 to 1989 did capital productivity recover with the switch to a more labour-intensive production process (see Graph 9), but at a rather low rate as labour productivity growth was affected downwards by the reduction in capital intensity. As a consequence, the profitability of fixed capital for the Community remains significantly lower in comparison with its level of the 'golden 1960s', even for the peak reached in 1989.

GRAPH 8: **Profitability of capital stock**



Source: Commission services.

GRAPH 9: **Capital productivity**



[1] Capital intensity = capital stock per employee (K/L).
Source: Commission services.

2.4.2. Structural reform: progress at Member State level

As Chapter II of this report shows, progress has been achieved towards tackling structural obstacles to increased growth in output and employment at the Community level, notably through the internal market programme. This should, however, be accompanied by further progress at the level of individual Member States. There is already an increased recognition by Member States that structural rigidities affecting their national economies must be tackled. This is a welcome contrast with the past when they were frequently postponed, as the short-term costs outweighed the much greater long-term gains; in some cases e.g. Spain, structural reform is an important element of the convergence programmes. These structural reforms are geared to improve the functioning of markets and cover a wide spectrum of domains.

Reforms to improve the adaptability of labour markets and wage moderation

Measures are being pursued to increase work incentives in order to improve labour supply, often through reform of social security systems. These measures include more stringent eligibility requirements for payment of pensions (increase in retirement age and/or qualifying period in France, Portugal and Italy), reduced access to invalidity pensions (the Netherlands) and a much closer integration of the taxation and welfare systems (Ireland and Denmark); unemployment benefit systems have been reformed (Denmark) and/or stricter rules governing payment of unemployment benefits have been enforced (Belgium and Spain). A much increased emphasis on improved training opportunities, particularly for the long-term unemployed, is evident in virtually all Member States.

Similarly, measures have or are being taken throughout the Community to improve the demand for labour such as greater access of employers and workers to part-time working, temporary contracts, job sharing, temporary leave for family/study purposes, legalization of private employment agencies, etc. The United Kingdom, in particular, undertook a major reform of the labour market in the 1980s. The high level of social security contributions in Member States is also considered to be depressing the demand for labour. This has led to the reduction of such charges for employers in certain categories in Belgium (with the consequential loss in revenue being funded through increased energy taxes), France and Spain.

In addition to these reforms, which will bear their fruits mainly in the medium to long term, Member States have more recently addressed the issue of wage moderation. Wage developments have been slow to respond to the economic downturn and the sharp rise in unemployment, thus dampening the prospects for recovery. Member States have, accordingly, taken several measures to promote improved wage moderation. This strategy, recommended by the Edinburgh European Council in December 1992, has led to a sharp reduction in public sector wage growth. This in turn is helping to reduce wage pressures generally. In most Member States (e.g. Italy, the United Kingdom, Greece, Spain, Portugal, Germany, the Netherlands and Denmark), the rise in public sector wages in 1994 is currently projected to again remain at or below the rate of inflation. This improved public sector wage moderation is also sharply reducing the rate of growth of public consumption, thus facilitating the consolidation of budget deficits.

Labour market issues, from structural reform to wage moderation, have in some Member States been part of social pacts or agreements. This strategy has been particularly successful in Italy, where the abolition of the indexation of wages ('scala mobile') in 1992 has been followed in July 1993 by agreement that future wage developments must be consistent with agreed inflation targets. Similarly, in Germany, the social partners have agreed to an extended timetable for the equalization of wages between the eastern and western *Länder* in key industrial sectors. Spain, Ireland and Portugal are all currently negotiating social pacts where the needs of employment, wage moderation and the consolidation of public finances figure very prominently.

Increased competition

The implementation of the single market is the major initiative in the Community's history aimed at increasing competition. However, apart from the transposition of the required Community legislation into national legislation, Member States have also taken domestic initiatives to promote competition. These range from the privatization programmes being followed in several Member States (Belgium, France, Ireland, Italy and Portugal), the abolition of State monopolies (Spain), the reduction or reorientation of subsidies (Germany and Ireland) and the lifting of administrative and legal barriers to market entry (Greece). In many cases these measures have the additional benefit of improving the public finances of the countries concerned.

Fiscal consolidation and improving the structure of public expenditure and tax systems

Medium-term strategies for fiscal consolidation constitute one of the main elements of the convergence programmes, as said above. Besides the positive effects stemming from the reduction of budget deficits, Member States have also attached importance to improving the structure of public expenditure and tax systems. In particular, a growth-oriented pattern of public expenditure is being pursued since recession started to emerge.

Member States have attached priority to public investment in their spending plans in order to avoid a repetition of the experience of previous recessions when it was the first casualty of expenditure cutbacks. This strategy is meeting with a positive response and public investment in the Community has continued to escape the brunt of spending cuts. This in turn is offsetting the impact of the very sharp fall-off in private investment on total investment growth. The available budgetary plans for Member States for 1994 point to a broad continuation of this strategy and to greater emphasis on restraint in current expenditure. Several countries have also been pursuing tax reforms (e.g. Denmark and Greece) intended to simplify their tax systems, to reduce distortions and disincentives, and/or to improve the efficiency of tax collection.

Besides the priority to public investment, measures to improve business investment feature strongly in all Member States' strategies, particularly in relation to small and medium-sized enterprises. These are largely concentrated on tax incentives or tax reductions for enterprises, loan subsidies for start-up businesses or measures to boost private housing demand and hence the construction industry. The newly created funds in Portugal which are providing risk capital to firms are such an example. In the Netherlands, the new 'industrial facility' is a similar initiative. In France, a major portion of the proceeds of the 'Balladur bond' is being used to ease the cash-flow problems of SMEs arising from VAT payments. In addition, there is an increased emphasis throughout the Community on reducing or simplifying regulations and planning procedures affecting private investment.

2.5. Central bank independence

The Treaty on European Union distinguishes three phases in the process towards full independence of national central banks. In a first step, the ban on central bank financing of the public sector, which is an important element of central bank independence, will apply from 1 January 1994. To comply with this provision, Member States have to adopt the necessary measures already ahead of the start of Stage II. Secondly, during Stage II of EMU, Member States shall, as appropriate, start the process leading to the independence of central banks. Finally, at the latest at the date of the establishment of the European System of Central Banks (ESCB), national legislation including the statutes of its national central bank will have to be compatible with the Treaty and the Statute of the ESCB.

A number of Member States have recently taken measures to render their central banks more independent. Belgium, Italy and Portugal have adapted their central bank laws, primarily focusing on the prohibition of central bank financing of the public sector. France and Spain are in the process of major reforms of their central bank acts. In other countries internal discussions on the issue have started within the government/central bank. The main driving force behind these moves has been the greater credibility of the stability orientation and consequently the lowering of the interest rate risk premium in these countries.

The changes undertaken so far are encouraging in several respects. Firstly, the convergence in the institutional framework for economic and monetary policy mirrors a growing consensus on the role of monetary policy, paving the way for the closer coordination of national policies during Stage II. Secondly, the fact that Member States adopt measures far ahead of the timetable required by the Treaty shows that Member States are not following a 'minimalist approach' in the compliance with Treaty provisions. Although not at all required at this stage and despite the difficulties involved in designing at the present time a central bank law both suitable for the different institutional set-ups of Stages II and III, the changes in many respects already establish a high degree of compatibility with the Treaty.

The Belgian central bank law was amended in March 1993. In line with Article 104 of the Treaty, it completely abolishes central bank financing of the government; furthermore, the new act abolishes the censurer's veto right in the field of monetary policy, foreign exchange operations, the holding and management of official reserves and the promotion of the smooth operation of the payment systems, i.e. in the areas constituting the future tasks of the ESCB.

In Greece, according to a bill adopted in 1992, central bank financing of the government through its overdraft facility was halved; this overdraft facility is going to be abolished on 1 January 1994.

In Spain, the government submitted a draft law to Parliament at the end of 1992. Following the June 1993 general election, a new draft has been submitted according to constitutional rules, and the law is envisaged to enter into force on 1 January 1994. The draft law ensures full autonomy to the Banco de España and grants it sole responsibility for monetary policy.

In France, a new central bank law was passed by Parliament in July 1993; part of it was declared anti-constitutional by the Constitutional Council in August. The law was published as amended by the Constitutional Council. The Treaty having entered into force, the French Government intends to submit the remaining parts of the law to Parliament. The law notably abolishes any central bank financing of the public sector; the governor is appointed for a fixed term of six years.

In Italy, the central bank was granted sole responsibility for discount rate changes in February 1992 (Law No 82 of 7 February 1992). In November 1993, Parliament passed a law abolishing any form of credit line of the government with the central bank.

In Luxembourg, the government is currently (mid-November 1993) in the process of putting before Parliament a major reform of the law relating to the Institut monétaire luxembourgeois. The draft would incorporate the Treaty provisions on central bank independence including central bank financing.

In Portugal, a major reform of the central bank law took place in October 1990. The Bank of Portugal was formally granted the sole responsibility for the implementation of monetary and exchange rate policy. Credit to the government was formally forbidden, although some exceptions still persist, e.g. primary market purchases of government bonds are still possible, although under very restrictive conditions. The credit line for the government was abolished at the end of 1992.

Apart from these initiatives, all Member States are currently in the process of adjusting national practices and legislation to the requirements of the prohibition of central bank financing of the public sector and to the prohibition of privileged access of the public sector to financial institutions.

II — Assessment of the implementation of Community law regarding the internal market

1. Introduction

1 January 1993 marked the beginning of a new stage in the development of the internal market. The objective set out in Article 8a of the Treaty, as amended by the Single European Act, has largely been achieved, except for the removal of identity controls on persons at all the internal borders. By the deadline, 95% of the basic legislative programme foreseen in the Commission's 1985 White Paper had been adopted by the Council. In certain sectors, not covered by the 1985 White Paper programme, notably energy and telecommunications services, considerable work has still to be undertaken to create a single market.

Firms can now operate in an environment that allows them to trade in products and services and fosters closer integration of cooperation and hence of the industrial fabric.

This has been achieved through progress in the following fields:

(i) Harmonization of technical rules as provided for in the White Paper has now been completed; initially confined to specific limited areas, it was extended to cover entire sectors such as agriculture and food products, pharmaceutical products and motor vehicles. Harmonization of essential product safety requirements, backed up by a policy of certification, and the general provisions on product safety and liability for defective products mean that all manufactured products marketed in the Community are now covered.

(ii) The measures have been adopted to permit public contracts to open to competition from firms in other Member States, irrespective of whether such contracts are awarded by public authorities or public services and are intended for the purchase of supplies, the purchase of services or the carrying-out of work. The relevant directives include provisions on appeal procedures allowing national courts to review matters.

(iii) Freedom to provide services will soon become a reality, where this is not the case already, with the gradual entry into force of the directives and regulations adopted on transport, financial services, telecommunications, recognition of diplomas, and the equivalence of professional qualifications. A final decision paving the way for the liberalization of road cabotage was adopted in October.

(iv) Since it is not enough simply to provide for freedom of movement and since firms must also be in a position to derive full benefit from it through corporate restructuring and the restructuring of their business strategies, the proposals on company law, company taxation, and industrial and intellectual property formed an integral part of the programme. The relevant objectives have been only partially achieved since, although most of the harmonization measures relating to industrial and intellectual property have been adopted and although certain forms of double taxation have been eliminated, the key proposals are still before the Council, i.e. those relating to the European company statute, the establishment of a trade marks office and the complete elimination of taxation at source on interest and royalty payments and taking into account losses suffered abroad.

(v) Such measures relating to the opening-up of markets to flows of products, services and capital from other Member States have been made irreversible by the elimination of all administrative checks at intra-Community frontiers. The abolition on 1 January 1993 of the single administrative document in intra-Community trade and the entry into force of a series of provisions reorganizing tax, veterinary, plant-health, health, safety and statistical controls have made it possible to do away with checks at frontiers.

(vi) Freedom of movement for individuals properly speaking has not yet become a reality. Individuals also benefit from the dismantling of customs and tax controls at internal frontiers, and Community nationals may now work in any other Member State thanks to recognition of their diplomas and qualifications and may reside in any other Member State regardless of any economic activity. Despite this, checks on persons are still carried out at internal borders although these have already been lightened. As underlined at the recent Schengen ministerial meeting on 18 October 1993, these controls shall be abolished by 1 February 1994.

2. Functioning of the single market

2.1. Implementation and transposition of Community legislation

Of the 282 White Paper measures, 264 have been adopted by the Council (95%). The transposition in the national legislations is proceeding: 261 White Paper measures have entered into force (90%), of which 219 require national transposition measures. Of the total number of necessary transposition measures 85% have been taken. One hundred and ten of the 218 measures have been transposed in all 12 Member States, 28 in 11 Member States, 21 in 10 Member States, 62 in nine or fewer (of which 21 in five or fewer) Member States.

An analysis by Member State shows that Denmark has taken 94% of the necessary transposition measures, followed by the UK (90%), Italy and Belgium (89%). Most delays in transposition are in Ireland (80%), Germany (78%) and Greece (75%). When broken down by sector, it emerges that transposition has been completed or is above average in the areas of freedom of movement of capital, in elimination of physical frontiers (various controls and controls on persons), in financial services (excluding insurance), in elimination of technical barriers, company taxation, VAT and excise duties.

When analysing the rate of transposition it is important to bear in mind the fact that certain items of legislation will only enter into force in 1994 and 1995. This fact can influence the speed with which measures are transposed, to the extent that Member States accord lower priority to those measures which are scheduled to come into effect at a later date. Nevertheless, the Commission remains concerned with the extent of delays in the following areas:

(i) Company law: with the exception of the European Economic Interest Grouping, just 60% of the necessary national transposition measures concerning the five Community legislative acts have been taken.

(ii) Intellectual and industrial property: the delays in transposition are concentrated on the directives on legal protection of registered marks and on protection of computer programs which only entered into force since the beginning of the year. Further difficulties in transposition are caused by the complex and technical nature of legislation in this field. The level of transposition comes to 61%. In addition, the Convention on the Community Patent has not yet been ratified by all Member States to enable its entry into force.

(iii) Public procurement: only 62% of the necessary transposition measures have been taken. In respect of two directives in the excluded sectors, relating to works and supplies, and legal remedies, transposition measures have been taken in six and three Member States respectively. In addition, the directive on services which entered into force on 1 July 1993 has been transposed so far in only three Member States.

(iv) Financial services: while the transposition of measures in the banking and investment services sectors is above average (90% and 87% respectively), the level of transposition in the insurance sector is 73%, where there are important delays in transposition by Greece, Spain and Luxembourg.

(v) Free movement of labour and professions: 75% of the necessary transposition measures have been taken. The first general directive on the mutual recognition of professional qualifications has been transposed correctly in eight Member States. With regard to the directives on right of residence, important delays in transposition persist, in particular in France and Germany.

It is still too early to draw general conclusions about the practical operation of the single market mainly because, taking account of the periods for transposition, economic operators and citizens have not had the time to take advantage or experience the effects of the new rules. The Commission has, however, received only a limited number of complaints concerning possible deficiencies in the legislation. Although some measures to accompany the abolition of border controls on goods have not yet entered into force (transfer of wastes, repatriation of cultural goods, sales of explosives, etc.), any difficulties experienced in the interim are being dealt with through closer administrative cooperation between the authorities of the Member States and with the Commission.

Apart from inevitable teething problems which have either already been resolved or are in the process of resolution, the 'transitional' VAT system has performed well and has facilitated the free circulation of products. Nevertheless, economic operators have drawn attention to difficulties relating to specific provisions of the specialized regimes. This has been the case, notably, with respect to the requirement for firms with a level of turnover in another Member State in excess of a certain threshold to appoint a fiscal representative. These difficulties have been examined by the Comité d'écoute des entreprises, established by the Commission. In a number of cases, these problems have already been effectively tackled. On the whole, the experience with the operation of the 'transitional' VAT system has been largely positive. The Commission will make further proposals for appropriate simplification as required. Moreover a full report will be prepared by the Commission on the working of the transitional VAT regime which will be presented to the Council at the end of 1994 together with proposals for the adoption of a definitive VAT regime, which will allow a further reduction in the administrative burden on businesses in the Community.

2.2. Making the single market work

The work of building the single market did not end with the opening of the internal frontiers on 1 January 1993. The Commission is determined to ensure and reinforce progressively the effectiveness of the single market. This task is the subject of the preparation of a strategic programme by the Commission, based on its working document (COM(93) 256 of 2 June 1993). It takes into account proposed actions set out in its communication of 2 December 1992 (SEC(92) 2277) in response to the Sutherland report 'The internal market after 1992: meeting the challenge'.

The proper functioning of the single market is the basis for the improvement of living conditions of the Community's citizens. The objectives outlined in the strategic programme are clearly approached from this perspective. These objectives are:

(i) to respond to the expectations of citizens;

(ii) to ensure a competitive environment for enterprises and to ensure that consumers and enterprises will be able to take an active part in the functioning of the internal market and take advantage of the possibilities that the internal market offers them;

(iii) to ensure the impetus for economic and social development in the single market.

To fulfil these objectives precise lines of action for an effective application of the regulations and a dynamic development of the internal market are presented in the working document attached to the abovementioned communication.

For an effective application

(i) The instruments of control with respect to Community obligations as laid down in the Treaty of Rome will be fully exploited to prevent new obstacles to trade. The extension to the services sector of the notification mechanism for new technical rules in the field of goods is under consideration.

(ii) The effective application of the single market regulations in all Member States requires the full transposition of Community legislation, the monitoring of the conformity of national transposition measures and the monitoring of the convergent implementation of these rules in all Member States, based on clear interpretations to be provided by the Commission. A satisfactory framework for control has to be set up to assure the Member States that surveillance of the functioning of the regulations is being carried out. Improved access to justice and judicial cooperation will create real confidence in the single market whilst individuals and enterprises should be aware of proper and effective means of redress in case of violations of their rights. Consideration should be given to the promotion of training of lawyers in Community law, to better transparency of possible sanctions and to effective enforcement of judgments between Member States (the Brussels Convention).

(iii) Initiatives for the organization of partnership with the Member States are envisaged in the fields of administrative cooperation between the Member States and between the Member States and the Commission, in order to ensure the effective application of Community law and to create an atmosphere of mutual confidence.This includes improvement of early warning systems for dangerous goods, the introduction of early warning systems in the services sector, improvement of the administrative infrastructure, training for officials, exchange programmes — some are already in operation — and setting up data transmission networks between administrations.

(iv) The transparency of Community actions also requires formal and informal consolidation of Community legislation. A communication on consolidation requirements in the internal market field will be published shortly. Furthermore, the Commission intends to improve information on and circulation of information in the single market, also by using already existing networks as the Euro-Info Centres.

For a dynamic development

The dynamic development of the internal market has to be placed in the context of many Community activities, in particular the initiatives for the promotion of economic growth, competitiveness and employment. It should be also borne in mind that the further development of the internal market has to be accomplished by strengthening social and economic cohesion, social policy, environment and research policy, as well as actions to ensure that the interests and rights of consumers are fully taken into account as the internal market evolves. These objectives are also in compliance with the results of the European Council at Copenhagen.

The current discussion of the strategic programme and the White Paper on competitiveness, growth and employment are closely linked. The White Paper will outline future policy on the internal market and refer to the strategic programme which will set out the actions to be carried out. At the European Council on 10 December 1993 the broad policy outline, contained in the White Paper, will be discussed. The formal presentation of the strategic programme will take place at the meeting of the internal market Council on 16 December 1993.

Additionally the dynamic development of the internal market relies also on the pursuit of many current actions. Measures are under way, for example, in the fields of intellectual property and of protection of personal data, on standardization policy. In particular, in recognition of the importance of SMEs' potential for growth and employment creation, the Council has adopted a multiannual programme to assist SMEs to rise to the challenges and opportunities inherent in the internal market. On the occasion of the first SME Council on 11 November 1993, it issued a Resolution calling for a second generation of Community actions to cater for the needs and interests of SMEs.

Community policies which interact with the internal market

New initiatives are envisaged by the Commission as a means of ensuring that the full economic and industrial benefits of the single market are realized. These measures are in particular intended to:

(i) improve the tax environment for enterprises so as to eliminate obstacles to cooperation and cross-border activities;

(ii) promote quality in European industry;

(iii) develop an integrated approach to trans-European networks in the fields of energy, transport, telecommunications and telematics networks;

(iv) encourage special actions to assist SMEs to take full advantage of the benefits of a single market.

In addition, the Commission is examining ways in which the interrelationships between other Community policies and the internal market can be developed and improved with a view to ensuring the proper functioning of the internal market, and the effective realization of other Community objectives. In particular:

(i) a vigilant application of competition policy safeguards must prevent the liberalization generated by the internal market programme from being undermined by anti-competitive practices on the part of economic operators or governments;

(ii) the effective management of the Community's external frontiers and a dynamic commercial policy are essential if individuals and firms are to feel confident and secure in the absence of internal frontiers and if the growth of illiberal and protectionist reactions is to be avoided;

(iii) environment policy and the internal market must be coordinated so that the objectives of sustainable economic development and of guaranteeing the 'four freedoms' are met and so that potential conflicts are resolved on the basis of a coherent approach.

After having undertaken wide consultations with all concerned parties the Commission intends to adopt the definitive version of the strategic programme and to present it to the Council and Parliament before the end of 1993.

3. Elements for a preliminary assessment of the economic impact of the internal market programme

3.1. Introduction

The Community has scored an outstanding success in constructing the legislative framework necessary for the functioning of the internal market. During the course of this process, the Member States have demonstrated a commitment to the objective of a single market which has firmly established the credibility of this framework in the eyes of economic operators throughout the Community. The conviction that an internal market was in the making, and that it would herald significant new commercial opportunities, has prompted enterprises in many sectors to implement new investment and sales strategies. The pages which follow document actions undertaken by Community and third-country enterprises to gear up in anticipation of the single market. Nevertheless, these anticipation effects represent only the first chapter in the internal market story. The full range of economic benefits will only be realized once the new legislative framework is firmly embedded, and once economic operators have had sufficient time to take full advantage of efficiency improvements and new commercial openings.

The current recession, which cannot be attributed to the restructuring contingent on internal market completion, has nevertheless obscured the benefits which were expected to flow from this process. In this respect, it is important to emphasize that progress towards the realization of an internal market will strengthen the underlying competitive strengths of the industrial and services sectors concerned, and thereby provide the best guarantee for sustainable recovery once macroeconomic conditions improve. Furthermore, the internal market has acted as a brake on any temptation on the part of Member States to renationalize certain elements of economic, monetary or commercial policy. Any misguided return to 'go-it-alone' policies would have proved counter-productive for economic operators and the Member States concerned.

The following paragraphs try to bring together some preliminary indicators which suggest that, even at this early stage in the process, the enabling legislation of the internal market programme is beginning to make its influence felt in certain sectors of the EC economy. For a number of reasons, it is too early to attempt a global assessment of the economic impact of the internal market.

(i) Firstly, much internal market legislation is only beginning to make its effects felt. Indeed, in many areas (e.g., insurance, public procurement) important elements of the legislative framework will only enter into force over the coming months.

(ii) Appropriate complementary measures, such as trans-European networks and actions to help SMEs, must be put in place if the full potential of the internal market is to be realized.

(iii) Economic operators have to become accustomed to the new framework, and to adapt their activities accordingly.

A fundamental precondition for a wholehearted private-sector response to the internal market programme is that the legislative framework be seen to work, and enjoy full credibility in the eyes of economic operators. The forthcoming strategic programme on the functioning of the internal market is intended to ensure that the effectiveness of this legislative framework be sustained and further developed by tackling the issues raised above. In particular, the strategic programme aims to improve the Community capacity to ensure implementation and enforcement, to develop appropriate flanking measures, and to deepen private sector understanding and familiarity with the internal market framework.

It would be premature to attempt a full-scale economic analysis of the impact of the internal market programme at this stage. Nevertheless, the following text tries to bring together some early indications that the internal market programme has stimulated certain economic processes which, over the longer term, will contribute to a strengthening of economic performance in the Community. Much of the evidence is related to the anticipatory response of the private sector to the internal market programme, for example cross-border investment activity. Information on the *ex-post* benefits which flow from the removal of internal border controls, the elimination of technical barriers, and other elements of the internal market programme which took effect on 1 January 1993, remains scanty and largely anecdotal for the time being. In addition, it is extremely difficult to extricate the effects of the internal market programme from other forces which are operating simultaneously on the EC economy.

These issues will be tackled in greater detail and on the basis of a fully worked out methodology in the wide-ranging study of the impact of the internal market which the Commission is preparing for 1996. This analysis will not focus only on the business dynamics linked to the realization of the internal market, but it will also take into account the effect of internal market completion on other Community objectives, such as the achievement of sustainable and non-inflationary growth respecting the environment, and the contribution to regional cohesion.[1]

The internal market programme is best understood as a supply-side initiative, designed to improve the structural soundness of the EC economies and to enhance the attractiveness of the Community as a base for industrial and service activities. This objective is to be achieved through the removal of legal and administrative obstacles which have traditionally denied many EC firms the possibility of corporate development through expansion onto partner-country markets. The primary effects of internal market completion will manifest themselves in the form of new commercial opportunities for individual companies, operating in sectors where hidden trade barriers were most prevalent. It is the capacity of individual companies to perceive new openings which have been created by the internal market, and their ability to capitalize on them which will drive forward the process of market integration and unleash the wider economic benefits described in the Cecchini report. In this respect, the internal market programme can be seen as a facilitator — it creates a framework conducive to corporate development, but it requires an appropriate response from industry and services before the promise of the internal market can be transformed into an improved business and economic performance.

The effects of the internal market programme will unfold over a number of stages:

(i) Initially, the internal market programme leads to a reduction in trade costs, and opens up access to previously sheltered sectors of the Member State markets. In turn, this should lead to the establishment of a number of new markets based on geographic proximity, similar cultural traditions and economic structures. Firms can then develop new or improved products to better serve these new markets.

(ii) One striking feature of the internal market process has been the way in which many companies have tried to anticipate the effects of internal market completion by adapting their operations proactively. The effects of these strategic responses on market structures will be a

1 Parameters as laid down in a Council Resolution of 7 December 1992: OJ C 334, 18.12.1992.

major determinant of the influence of the internal market on intra-EC trade and investment.

(iii) By facilitating increased economic interpenetration, the internal market should then increase competitive discipline in those sectors characterized by a high incidence of non-tariff barriers. Given the changing complexion of competition and trade, many companies will react by revising or overhauling their activities and strategies.

(iv) Ultimately, the reshuffling of market structures and business strategies may be reflected in a strengthening of the competitive position of individual companies or sectors.

At this early stage of the process, the immediate cost savings linked to barrier removal are becoming apparent. In addition, there is evidence that some companies are actively gearing up in preparation for the emerging single market. Finally, those sectors where internal market legislation has been in place for some time (e.g., some elements of technical legislation) are witnessing an evolution of intra-EC trade and a strengthening in cross-border competition which may be traced back to the completion of the single market.

3.2. Reduction in trade costs and removal of access barriers

The most visible result of the internal market programme to date has been the dismantling of administrative formalities on cross-border shipment of goods. A recent survey of 156 Euro-Info Centres confirms that the abolition of frontier controls on vehicles and cross-border shipments of goods has significantly increased the facility with which companies can bring their product to markets in other EC countries.[1] This development has reduced the need for many smaller companies to rely on the services of export agents when selling their products in other EC Member States. In addition, the abolition of border controls has speeded up delivery times for products, with a consequent reduction in transport costs. Estimates, provided by companies which engage in cross-border shipments, of the savings resulting from the removal of border delays are of the order of 3 to 4% of expenditure on international road transport. The savings will be significantly higher for short distance shipments across frontiers.

The removal of technical trade barriers is widely seen as one of the most significant benefits to be derived from the internal market programme.[2] However, it is impossible to provide an overall estimate of the savings that will result from the eradication of needless technical adaptation and duplication of conformity assessment costs. The savings which will flow from the emergence of common EC technical specifications and testing procedures will vary from product to product, as a function of the technical discrepancies which previously existed, and the cost structures of the products concerned. However, it can confidently be asserted that the potential savings will be sizeable for many sectors. In addition, by cutting out the need for product redesign and adaptation to match separate national requirements products can be brought to the market more quickly. These time savings could represent a significant benefit for products where product development costs are high, and product life-cycles are short.[3] However, it may take some time before common technical specifications come into widespread use, and before test results, certification procedures, and conformity marks provided in one Member State are accepted without reservation in another. The EIC survey underlined continued scope for improvement with respect to mutual recognition of national tests and certificates, and of CE-marked goods coming from other Member States.

EC public procurement legislation heralds a potentially dramatic shake-up of markets which have long been shielded from competitive pressures. However, this legislation has only recently come into effect for supplies, works (January 1993) and services (July 1993), and has yet to enter into force as far as public utilities are concerned (July 1994). It will take some time before the effects of this legislation on cross-border public procurement can be properly assessed. This point is clearly underscored in the EIC survey which notes that SMEs continue to encounter administrative obstacles, unrealistic deadlines, and difficulties in obtaining contracts and supporting documentation.

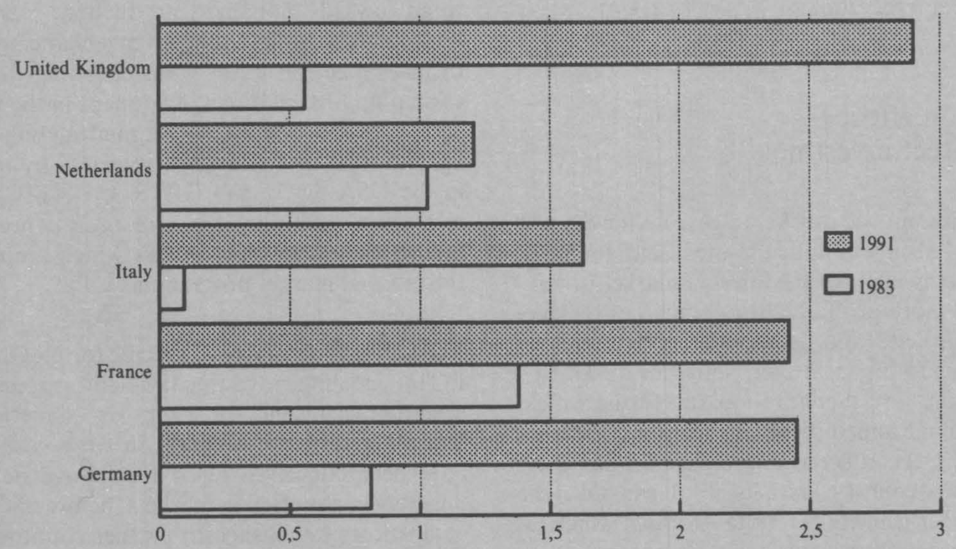
Controls on capital movements have, in the past, served to hamper cross-border investment in physical and financial assets, thereby denying investors opportunities to earn the highest return on their funds or preventing them from constructing preferred portfolios. Capital controls also constituted one of the most formidable obstacles to the cross-border provision of financial services, as financial institutions could not transfer liquidity from one area of operations to another at short notice. Since the abolition of frontier controls, capital market integration has been significantly intensified. Graphs 10 and 11 illustrate the increase in flows of portfolio investment between individual Member States and other countries. These graphs illustrate a sharp increase in portfolio investment into and out of all Member

1 EC Commission, Euro-Info Centre project (1993): EIC — Single market questionnaire, results.

2 European Observatory for SMEs (1993): First annual report.

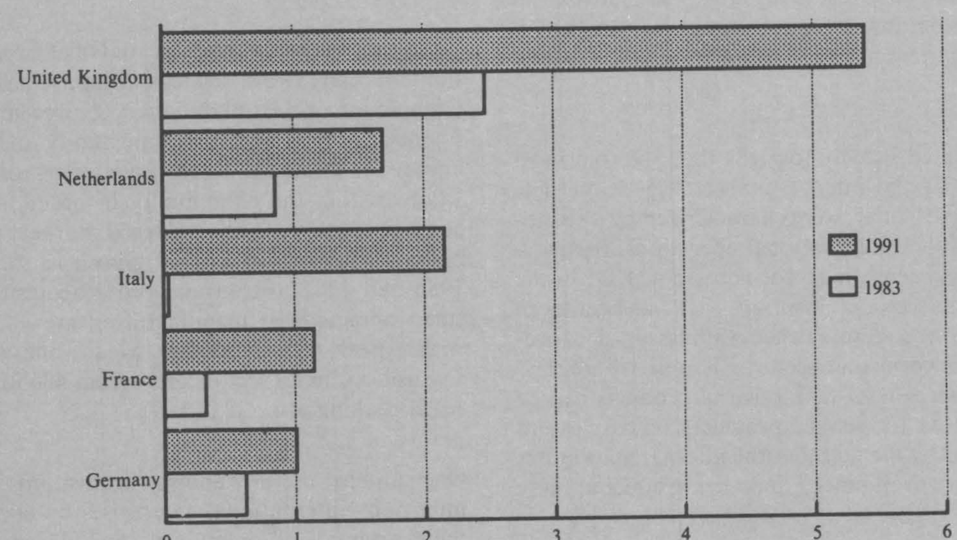
3 For instance, it has been estimated that a reduction in one month in the time needed to bring a new automobile model to market could generate gains of ECU 30 million for the manufacturer.

GRAPH 10: **Portfolio investment from other EC countries**



Source: Data are based on non-harmonized national data supplied to Eurostat.

GRAPH 11: **Portfolio investment in other EC countries**



Source: Data are based on non-harmonized national data supplied to Eurostat.

States examined. Taken together, this evidence suggests that the internal market programme has been accompanied by, and has contributed to, a qualitative increase in the degree of EC capital market integration.

3.3. Anticipation effects — Foreign direct investment

Many companies have moved quickly to gear up for the new opportunities and challenges implicit in the internal market. In particular, the completion of the internal market is making it progressively more profitable for companies to serve partner-country markets, and is making it increasingly worthwhile for firms to organize their activities on an EC-wide basis. Companies are therefore looking further afield when taking locational and investment decisions. Foreign direct investment (FDI) can act as one vehicle for company expansion on partner-country markets. FDI can take the form of a cross-border transfer of capital through which an investing enterprise creates a new foreign company, gains control (fully or partly) of an already existing enterprise, or develops the business of an already affiliated foreign company. FDI therefore involves managerial say over productive activities in another country.[1] The completion of the internal market encourages companies in one Member State to invest in partner countries in order to take advantage of location-specific advantages, to internalize assets of an acquired company, or to gain a foothold on the partner-country market. Foreign direct investment has increased in tandem with the programme for the completion of the internal market. This trend has been common to all EC Member States.

This FDI was oriented heavily towards those sectors most directly concerned by the internal market legislation. The services sectors, in particular, were characterized by a sweeping restructuring of their international operations. In absolute terms, there has been a marked increase in FDI in the finance and banking sectors. However, FDI has been even higher in other service sectors when expressed as a proportion of value-added in that sector. The relative importance of FDI in services *vis-à-vis* industrial products can be explained by the need for service providers to be close to their customers, and by the fact that the internal market has had a relatively more pronounced liberalizing effect in these industries.

[1] The OECD uses a threshold of 10% of the voting power of the affiliated company in order to distinguish investment designed to yield significant say in the management of an enterprise from portfolio investment.

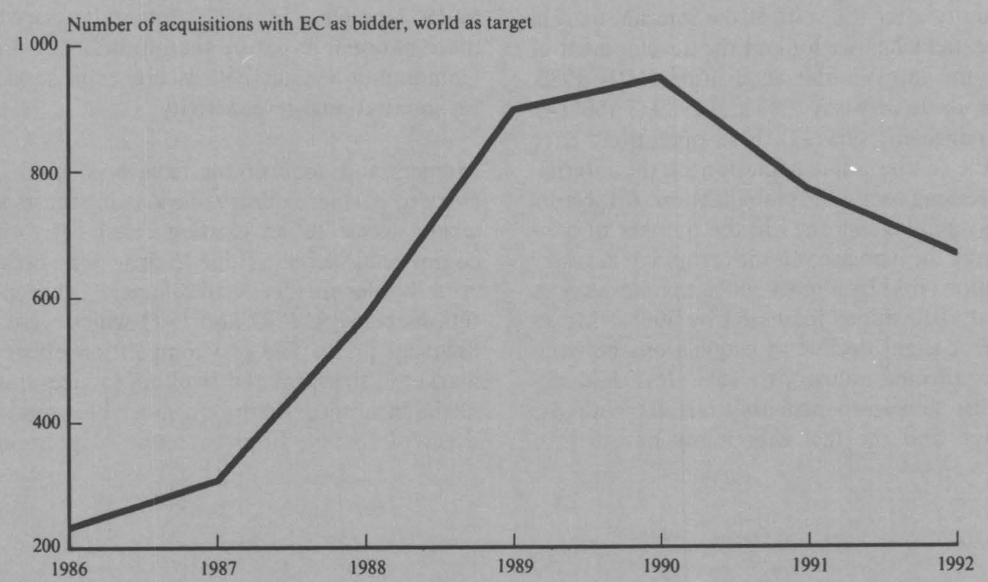
It is also interesting to note that non-Community companies have stepped up their investment in the Community. In large part, this development attests to an established worldwide trend towards globalized production. Nevertheless, the internal market programme — by enhancing the profitability of investment projects — has encouraged foreign investors to step up foreign direct investment in the Community. The success of the internal market in attracting foreign investors is confirmed by business surveys and by trade associations in the USA and Japan (JETRO, US ITC). Extra-EC FDI into the Community has also been concentrated in those industries and services sectors which are most affected by the internal market programme.

FDI can take a number of specific forms. One subset of intra-EC foreign direct investment which has received considerable attention in recent years consists of mergers, acquisitions and other forms of alliance. In some cases, these alliances have been conceived of as a defensive step to consolidate positions on national markets before the arrival of new competitors established in partner countries. However, the surge in the number of cross-border mergers and acquisitions in the latter half of the 1980s testifies to a growing tendency for many firms to conceive of their operations on a pan-European scale. Mergers, acquisitions and alliances are viewed as a means of acquiring an established foothold in partner-country markets, of internalizing assets which enhance the firms' corporate strengths, and of ensuring that its products have access to appropriate distribution networks.

To exploit the profitable potential of enlarged market opportunities, many firms' strategic response has been to expand. Completion of the internal market gives large industrial and financial groups both the opportunity and the incentive to engage in increased direct investment and foreign acquisitions within the Community in order to achieve a scale commensurate with the enlarged markets upon which they operate. As evidence of this, Graph 12 shows that between 1986 and 1992, total transborder acquisitions (controlling stake obtained) in manufacturing grew from 231 to 666, with a peak of 947 in 1990. Meanwhile, total transborder acquisitions in all sectors grew from 436 in 1986 to 1 162 in 1992, peaking at 1 722 in 1992.

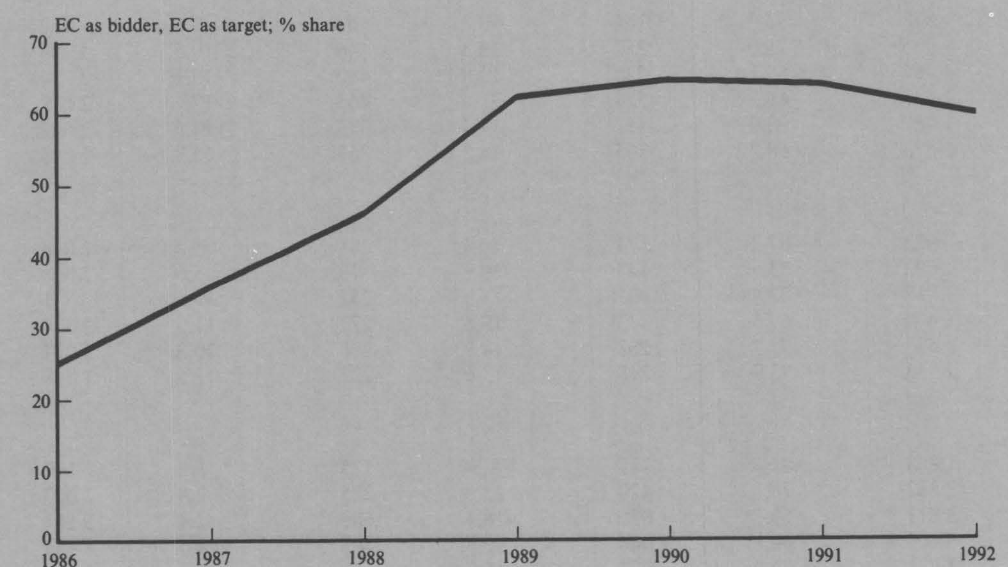
One can also usefully analyse acquisitions within the Community by international enterprises by taking into account their origin — Community, or international non-Community. Before 1986, less than 25% of the total number of transborder operations recorded were carried out by EC enterprises. Between 1989 and 1992, however, such operations have continually accounted for over 60% of total acquisitions in all sectors (see Graph 13). This provides a

GRAPH 12: **Total cross-border acquisitions — Manufacturing**



Source: Amdata.

GRAPH 13: **Share of total cross-border acquisitions**



Source: Amdata.

clear indication as to the extent of the pan-Europeanization process within EC firms.

This picture of increasing merger and acquisition activities inside the Community after the start of the internal market programme is repeated when we look at the development of both transborder and intra-border acquisitions after 1986. These grew spectacularly between 1987 and 1989 (Table 14). According to management surveys, these operations have frequently been due to the implementation of the internal market and to increasing economic globalization. All sectors have seen relatively similar increases in the number of concentrations, although the increase was more rapid in industry where these operations rose by almost 300% than in services where mergers and acquisitions increased by 200%. Moreover, the subsequent slight decline in acquisitions between 1989 and 1992 has affected industry (−15%) less than services (−23%). This slowdown probably reflects both the worldwide recession and the fact that many of the production rationalization possibilities sparked by the internal market programme have now been exploited. Most merger and acquisition activity is between enterprises of the same nationality even though their importance declined from 85% in 1987 to 66% in 1990. Activity in services tends to be more national in nature than in industry. In the same way, Community-level activity is higher in services than is true for international-level activity.

Mergers and acquisitions have been used as a vehicle for entry to partner-country markets in sectors such as banking where access to an existing retail network is crucial for commercial success. Table 15 provides a breakdown of those cross-border mergers and alliances between financial institutions between 1987 and 1993 which were reported in the financial press. The pro-competition effect of the internal market in financial and banking services has been mirrored in the insurance sectors. In most EC countries, the market share of foreign firms in terms of premiums written has

Table 14

Mergers and acquisitions inside the Community market by type of operation and by sector, 1987-92

	National operations		Community operations		International operations		Total operations	
	Number	%	Number	%	Number	%	Number	%
Industry								
1987	878	82,0	104	10,8	69	7,2	960	100
1988	985	71,0	257	18,5	146	10,5	1 388	100
1989	1 766	65,1	538	19,8	410	15,1	2 714	100
1990	1 648	61,5	574	21,4	457	17,1	2 679	100
1991	1 787	68,0	457	17,4	383	14,6	2 627	100
1992	1 573	68,2	365	15,8	367	15,9	2 305	100
Services								
1987	923	87,2	74	7,0	61	5,8	1 058	100
1988	1 092	83,5	143	10,9	73	5,6	1 308	100
1989	1 717	72,4	402	17,0	252	10,6	2 371	100
1990	1 624	69,6	433	18,6	277	11,9	2 334	100
1991	1 533	75,7	283	14,0	208	10,3	2 024	100
1992	1 343	73,9	248	13,6	227	12,5	1 818	100
Total								
1987	1 868	85,3	187	8,5	135	6,2	2 190	100
1988	2 382	78,7	420	13,9	225	7,4	3 027	100
1989	3 811	69,1	1 021	18,4	689	12,4	5 541	100
1990	3 606	66,1	1 066	19,5	783	14,4	5 455	100
1991	3 631	72,0	797	15,8	616	12,2	5 044	100
1992	3 247	71,3	651	14,3	655	14,4	4 553	100

Source: Amdata.

Table 15

Cross-border alliances between financial institutions, 1987-93
(by country of origin of target and initiating companies)

Initiating company's country	Target company's country									
	B	D	E	F	I	NL	P	UK	Other	Total
B		—	—	2	—	2	—	—	4	8
D	2		9	10	5	2	1	5	1	35
E	4	6		7	3	2	7	4	—	33
F	5	6	19		1	2	7	1	7	74
I	—	4	8	10		—	1	3	1	27
NL	4	2	4	5	1		1	5	2	24
P	—	—	3	1	—	—		—	—	4
UK	2	4	6	7	9	2	2		4	36
Other	—	—	—	2	—	—	—	4		6
Total	17	22	49	44	28	10	19	39	19	247

Source: Bank of England Quarterly Bulletin, August 1993.

been on the increase. By accentuating competition, domestic incumbent firms will be placed under pressure to adopt more cost-efficient practices, as well as to speed up the introduction of new products in response to consumer demands. However, strong defensive behaviour on the part of national incumbents could also offset the effects of increased foreign presence by providing domestic firms with a bulwark against increased cross-border competition. The trend towards smaller numbers of companies on insurance markets is a widely reported trend. The impact of these developments on the degree of competition will require detailed and sophisticated observation and analysis within the framework of existing competences, with a view to assessing the implications for the degree of competition on relevant markets.

In addition to cross-border investment and establishment, the internal market has elicited other strategic and organizational responses from firms. Individual companies have abandoned their traditional segmentation of the EC market into separate national divisions, upgraded product development and introduced quality management systems, and overhauled packaging, marketing and distribution systems. Prior to the internal market programme, firms maintained subsidiaries in various Member States at great expense, with separate registered offices and increased administrative and tax costs. Facilitated by more flexible and less costly transportation costs, corporations have tended to replace multiple regional or national locations by Euro-centralized production and distribution networks with more destinations. These developments have not yet been analysed systematically. Nevertheless, they represent a potentially significant category of reactions to the internal market programme.

3.4. Changes in intra-EC trade and competition

The success of the internal market hinges on the extent to which it succeeds in stimulating intra-EC trade and thereby providing a shot-in-the-arm to cross-border competition. Through this mechanism, the internal market programme will unleash new dynamics which may result in a strengthening of the industrial and services tissue of the EC economy. The internal market has to be seen in the context of the increasing globalization of the world economy for markets, production and finance. It should be seen as contributing to this process, and as a way of preparing Community firms for international competition. It would be inaccurate to interpret this process as a form of retrenchment on the Community market. The growth in intra-Community trade represents, therefore, an indicator of the increasingly international outlook of previously national-oriented firms, and does not constitute a handicap to, or an alternative for, the participation of Community firms on world markets.

Table 16 gives the share of each Member State's total exports and imports which are accounted for by intra-EC trade over a number of years. For both exports and imports, the period between 1980 and 1990 registered a significant increase in this share for the nine countries which comprised the Community in 1980, except for Ireland where the share has generally been much higher anyway. On average, intra-EC trade was approximately 11 points higher for imports in 1990 than in 1980, and nearly 10 points higher for exports. However, for exports, this development took place between 1985 and 1990 which suggests that the liberalizing effects of internal market legislation were beginning to filter through. For Greece, Spain and Portugal the combined effects of accession and deepening of economic integration through the internal market programme has led to spectacular increases in the export and import shares of 10 to 20 percentage points between 1985 and 1990.

All sectors are affected by the opening-up of markets due to the 1992 programme, but a certain number of manufacturing sectors have been more protected by non-tariff barriers than others due to a difference in standards, importance of frontier formalities, limited access to public procurement, and differences in VAT and excise regimes. Forty manufacturing sectors out of the 120 sectors which make up manufacturing industry were identified as being most sensitive to the removal of non-tariff barriers. For the 40 sectors which are expected to be most affected and to benefit most from internal market completion (high-tech industries, mechanical and electrical engineering and transport goods industries), exports to the EC market increased enormously between 1979 and 1992 when compared against exports to non-EC countries.

The reciprocal tendency for companies in the various Member States to enter into each other's markets in the quest for new market outlets should lead to keener competition on national markets in the sectors affected by the removal of non-tariff barriers. In particular, intra-EC trade may be leading to lower levels of concentration in national markets for products such as medical and surgical equipment, machine tools, electrical machinery, consumer electronics, and transmission equipment. Imports from other Member States in these sectors now account for an increased share of domestic consumption, which also amounts to greater competitive pressure on domestic producers. In order to evaluate the final impact of the internal market programme on market structures at national level, it would be necessary to take into account a range of other factors, including any defensive

Table 16

Share of intra-EC trade in total trade
Imports and exports by Member State

(%)

	1980		1985		1990		1992	
	Imports	Exports	Imports	Exports	Imports	Exports	Imports	Exports
Original six Member States								
B/L	61,6	73,2	68,6	70,2	70,7	75,1	71,2	74,8
F	52,0	55,4	59,4	53,7	64,9	62,7	65,7	63,1
D	49,4	51,1	53,1	49,7	54,3	54,3	54,7	54,1
I	46,2	51,6	47,1	48,2	57,4	58,2	58,8	57,7
NL	54,7	73,5	55,8	74,7	59,9	76,5	58,8	75,4
First enlargement								
DK	50,3	51,6	50,7	44,8	53,8	52,1	55,4	54,5
IRL	75,3	76,0	71,7	68,9	70,8	74,8	71,9	74,2
UK	40,9	45,0	47,3	48,8	51,0	52,6	50,7	55,5
Second and third enlargements								
GR	40,9	48,2	48,1	54,2	64,1	64,0	62,8	64,2
P	45,3	58,6	45,9	62,5	69,1	73,5	73,6	74,8
E	31,3	52,2	37,9	53,3	59,1	65,0	60,3	66,3
EUR 12	49,2	55,7	53,4	54,9	58,8	61,0	59,3	61,3

Source: Eurostat. The former system of statistics collection based on customs declarations at intra-Community frontiers was replaced on 1 January 1993 by Intrastat. For structural reasons, Intrastat results for the first quarter of 1993 cannot be compared with statistics collected under the former system.

reactions by domestic producers to increased cross-border competition. It will also be necessary to allow sufficient time for the new market structures to settle down before making any definitive pronouncements on the impact of the internal market programme on the degree of competition in previously sheltered sectors of national markets. These considerations could form a central part of the 1996 study on the impact of the internal market.

In certain services industries, the increased competition induced by internal market liberalization has had significant effects. One notable example is the case of air passenger transport. The introduction of fifth freedom rights (the freedom to pick up passengers in one Member State on an outward journey and to carry them to a third country, or to collect passengers in a third country on the return leg of a homeward journey) and consecutive cabotage has triggered a round of fare competition on a number of intra-EC routes.

Although the internal market has not yet reached its full potential, its credibility and irrevocability have exerted profound effects on business behaviour. On average, econometric calculations made by the Commission services show that the contribution of integration to economic growth, powered largely by significant anticipation effects, has accounted for around 0,4% per year during the period 1986-92.

4. Conclusions

The basic legislative framework underpinning the internal market is now almost fully in place. Over 90% of the White Paper measures are in force and the level of transposition of adopted directives into the laws of the Member States amounts to over 84%. The success of the introduction of the legislative programme by 1 January 1993, in accordance with the time-scale laid down in the Single Act, has exceeded most initial expectations. The Commission's proposal to draw up a strategic programme is intended to ensure the smooth functioning of the single market based on this framework. The Commission has no ambition to embark upon a second legislative programme comparable to the 1985 White Paper.

As far as it can be judged until now, the single market is operating properly without major difficulties — apart from transitional problems, particularly for small and medium-sized enterprises earlier this year.

It is too early to assess the full economic impact of the internal market, as firms have not yet had sufficient time to adjust to the new legislation and the process of transposition of measures into national laws is still continuing. Even though it will be some time before the effects of internal market legislation fully come on stream, it is already evident that this legislation has been the catalyst for a thorough shake-up of key industry and services sectors. By injecting a new dynamism into lethargic sectors, the internal market may pave the way for improved competitiveness on the part of individual EC companies. It is this qualitative shift in the degree of cross-border competition which will be the greatest legacy of the internal market. In turn, this structural change in the EC economy may act as the dynamo for further development of many EC industry and services sectors. The Commission will launch a large-scale study in 1994 with a view to completion by 1996 to analyse the full effect of the legislative programme.

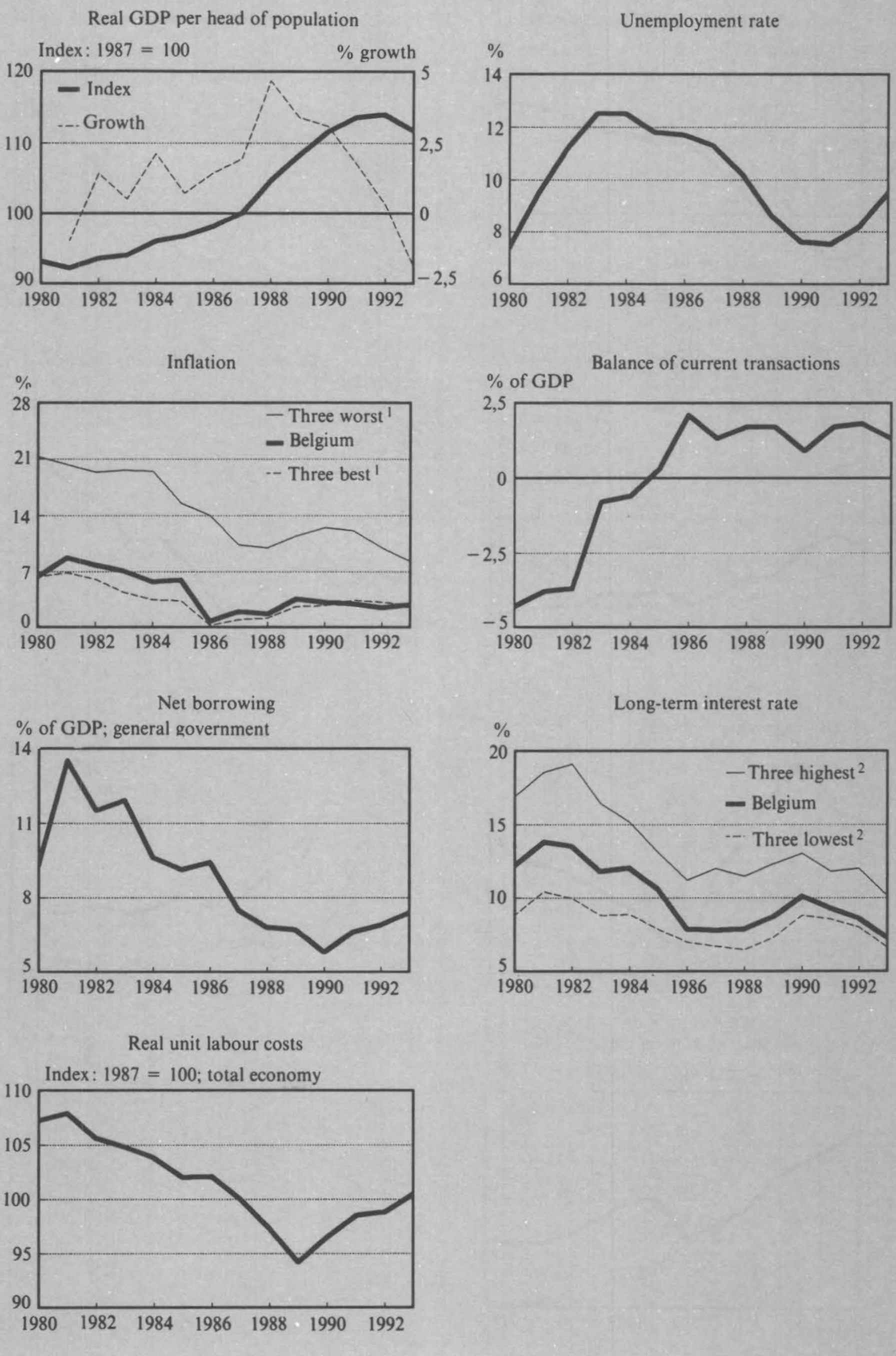
The process of the completion of the single market has strengthened the mutually profitable economic and commercial links between the Member States. This has been reflected in a steady increase in the proportion of intra-EC trade as a component of industrial and services output, and a Europeanization of company corporate and investment strategies to allow firms to take advantage of newly accessible commercial opportunities in other Member States. However, the internal market programme is not being constructed in an economic vacuum. The current recession, which has been provoked by forces unrelated to the completion of the internal market, has overshadowed the process of adaptation to the emerging single market framework. The depressed state of EC markets obscures the potential market openings created by the internal market. In addition, many, particularly small and medium-sized, companies do not have the resources or are wary of positioning themselves in order to take advantage of opportunities which lie around the corner. However, there are strong reasons to believe that the restructuring and investment undertaken during the late 1980s in anticipation of the internal market have helped to mitigate some of the effects of the current downturn. Looking forward, the single market will provide added impetus to the development of individual companies once economic recovery gets under way.

The widening of the scope for exchange-rate divergences has prompted concerns that increased 'exchange-rate risk' could dissuade companies from engaging in cross-border trade and investment. While 'exchange-rate risk' does introduce an added degree of uncertainty to transactions denominated in partner currencies, the impact on intra-EC trade and investment may be clearly offset through the use of hedging techniques. These, however, remain expensive, mainly for SMEs. Furthermore, exchange-rate stability, based on sound economic convergence, remains an essential component of the internal market, and it represents a prerequisite if the progress in liberalizing capital markets and financial services is to be safeguarded. From the point of view of the internal market, it is to be hoped that the macroeconomic conditions which are needed to sustain a high degree of exchange-rate stability can be restored at the earliest possible date.

Against this background the further reinforcement of an already well-established single market — as outlined in the strategic programme — is of major importance to counteract any negative tendencies. Maintenance of a stable and properly working single market will provide the basis for the realization of the second step of economic and monetary union. The widening of exchange-rate fluctuation bands has increased the risk of sudden competitive depreciations. The introduction of a single currency would remove this risk, as well as the nuisance and costs caused by the coexistence of several currencies in an integrated economic zone. The objective of a single currency remains a logical development of the largely achieved internal market programme.

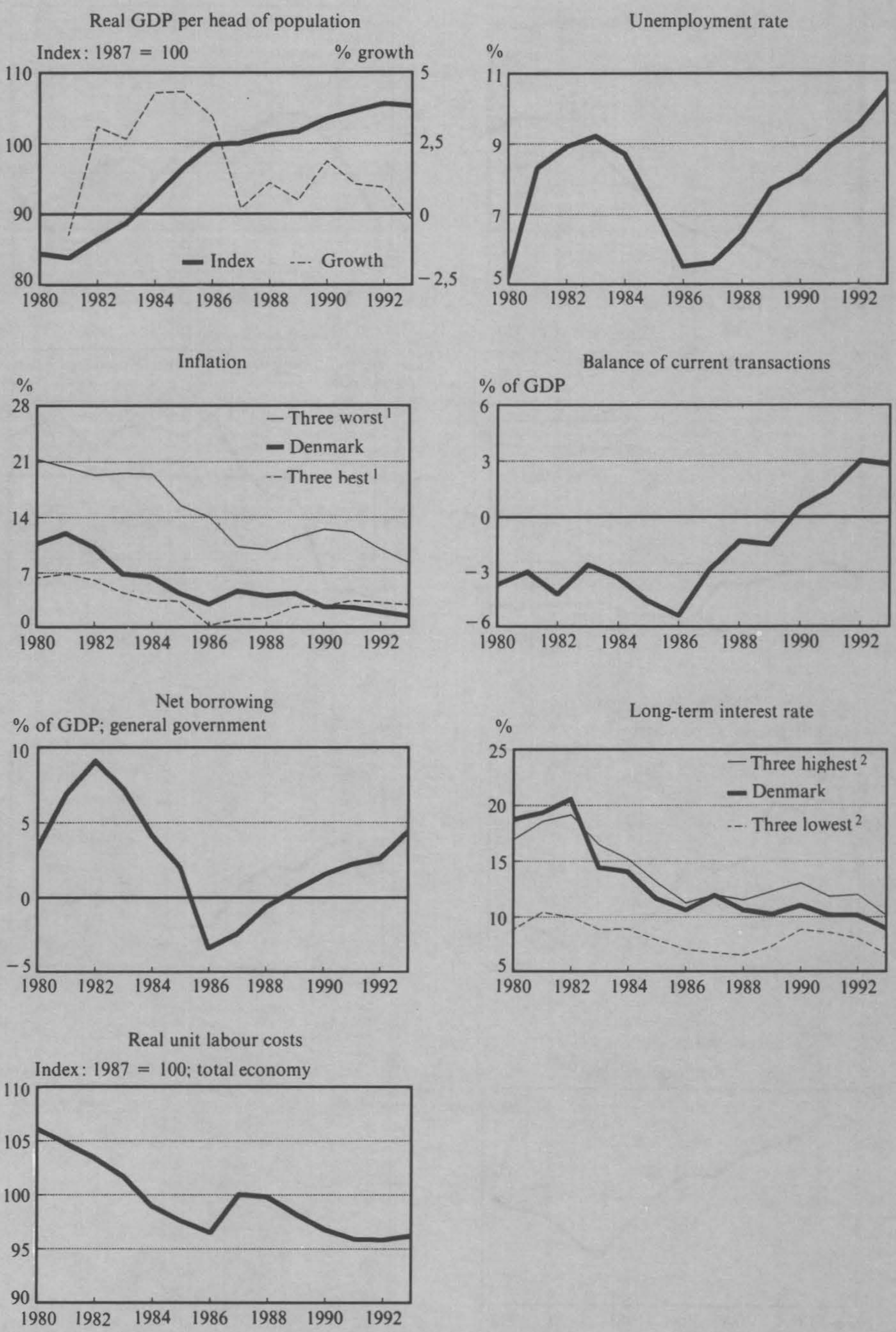
III — Annex: Graphs by Member State (1980-93)

Belgium



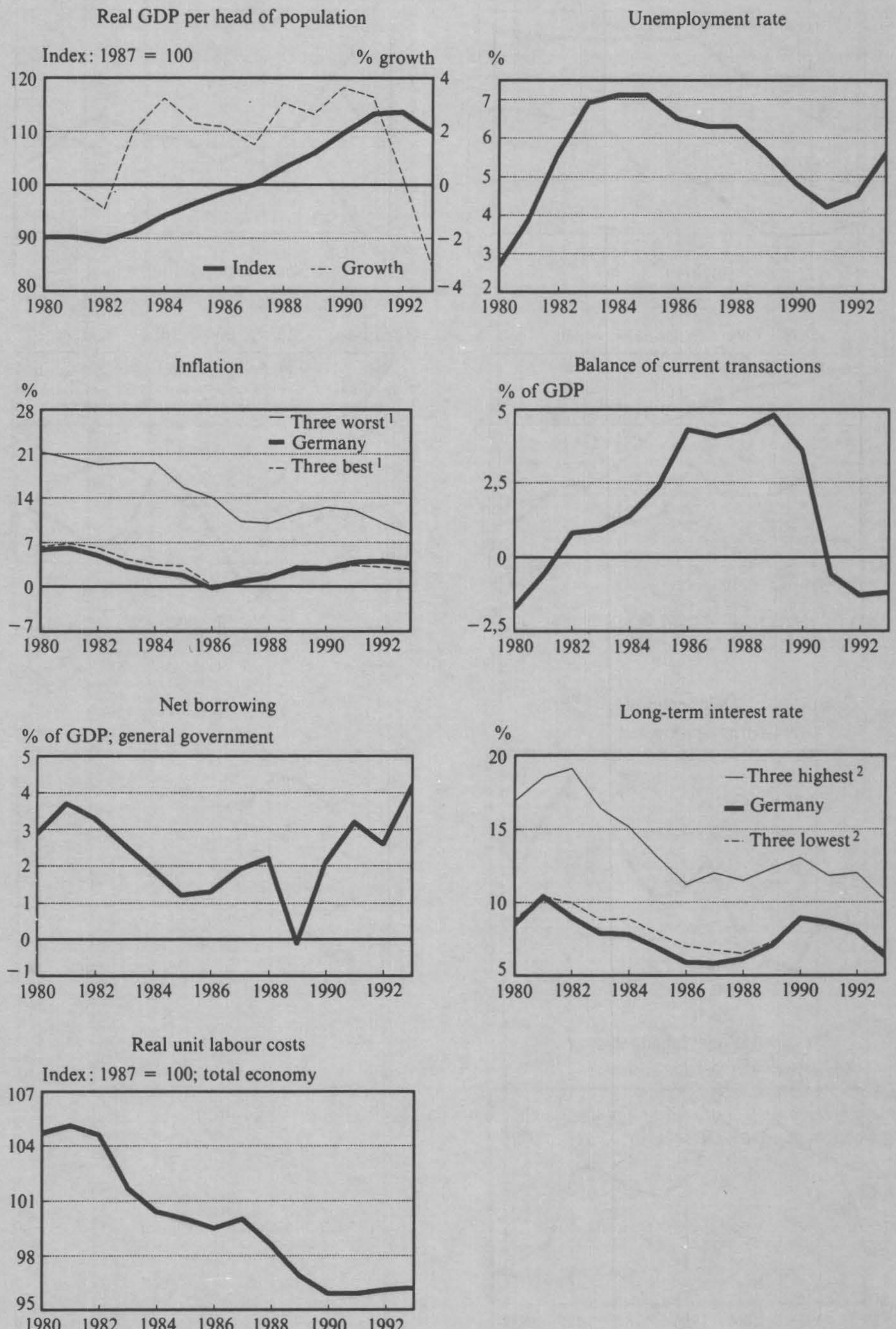
[1] Unweighted averages of the three best- or worst-performing Member States.
[2] Unweighted averages of the three highest or lowest rates in the Member States (excluding Greece and Portugal).
Source: Commission services, economic forecast (autumn 1993).

Denmark



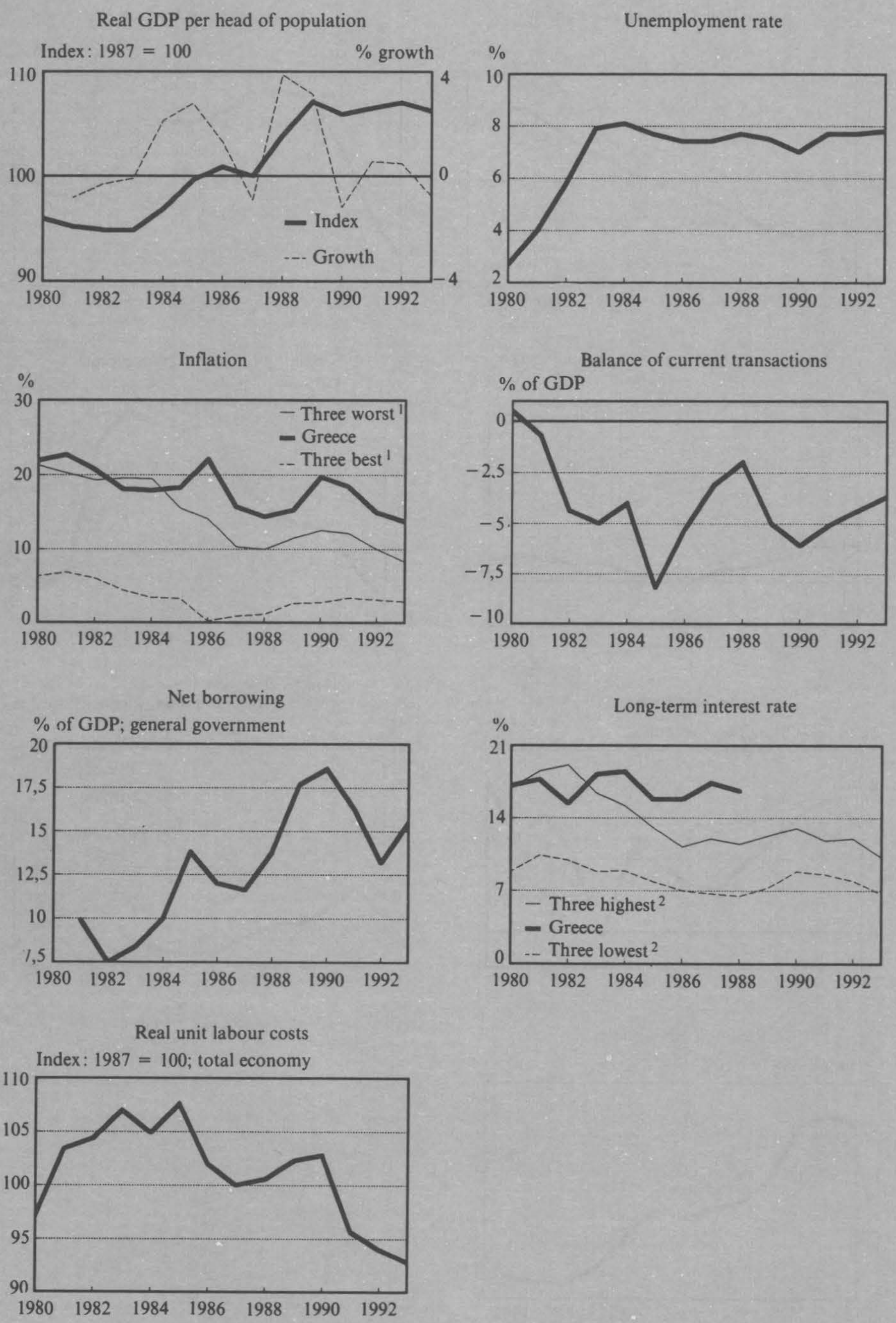
[1] Unweighted averages of the three best- or worst-performing Member States.
[2] Unweighted averages of the three highest or lowest rates in the Member States (excluding Greece and Portugal).
Source: Commission services, economic forecast (autumn 1993).

Germany



[1] Unweighted averages of the three best- or worst-performing Member States.
[2] Unweighted averages of the three highest or lowest rates in the Member States (excluding Greece and Portugal).
Source: Commission services, economic forecast (autumn 1993).

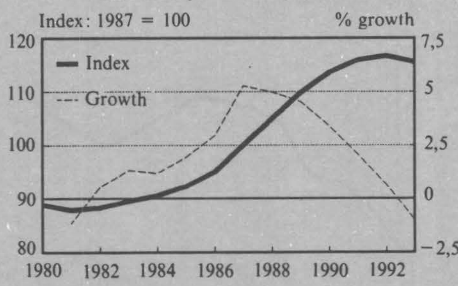
Greece



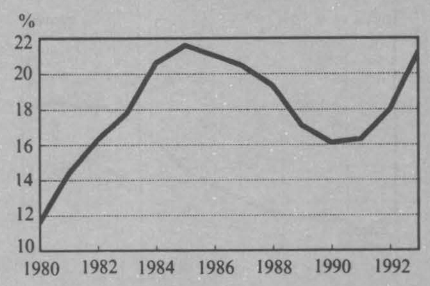
[1] Unweighted averages of the three best- or worst-performing Member States.
[2] Unweighted averages of the three highest or lowest rates in the Member States (excluding Greece and Portugal).
Source: Commission services, economic forecast (autumn 1993).

Spain

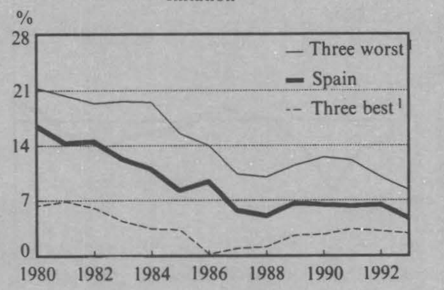
Real GDP per head of population



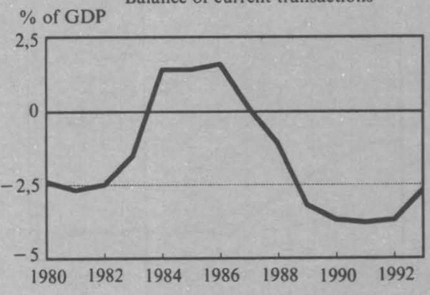
Unemployment rate



Inflation

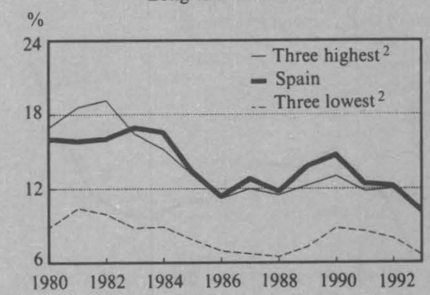


Balance of current transactions

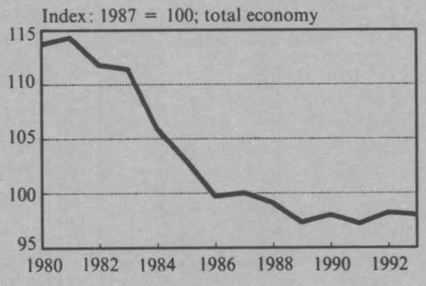


Net borrowing

Long-term interest rate

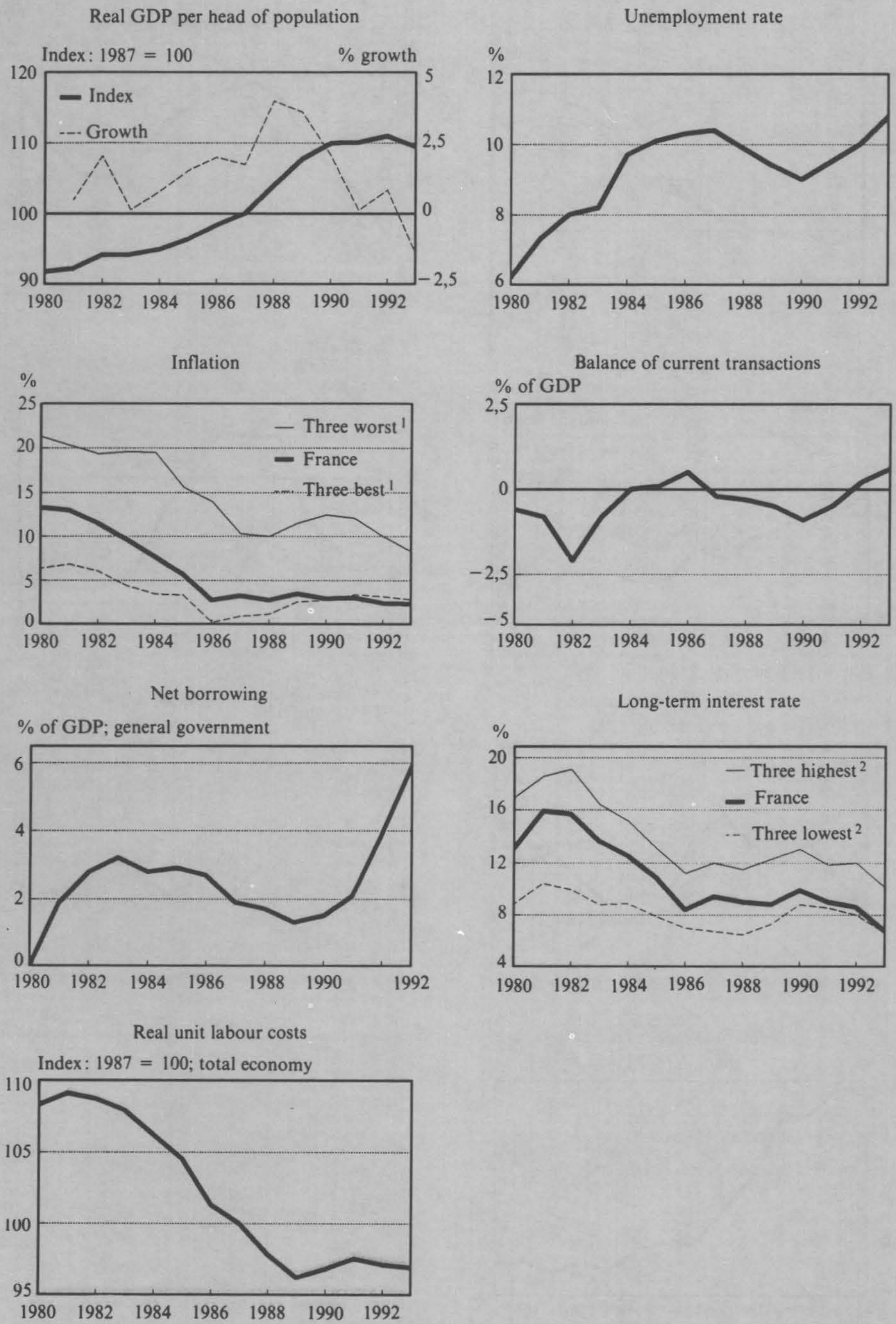


Real unit labour costs



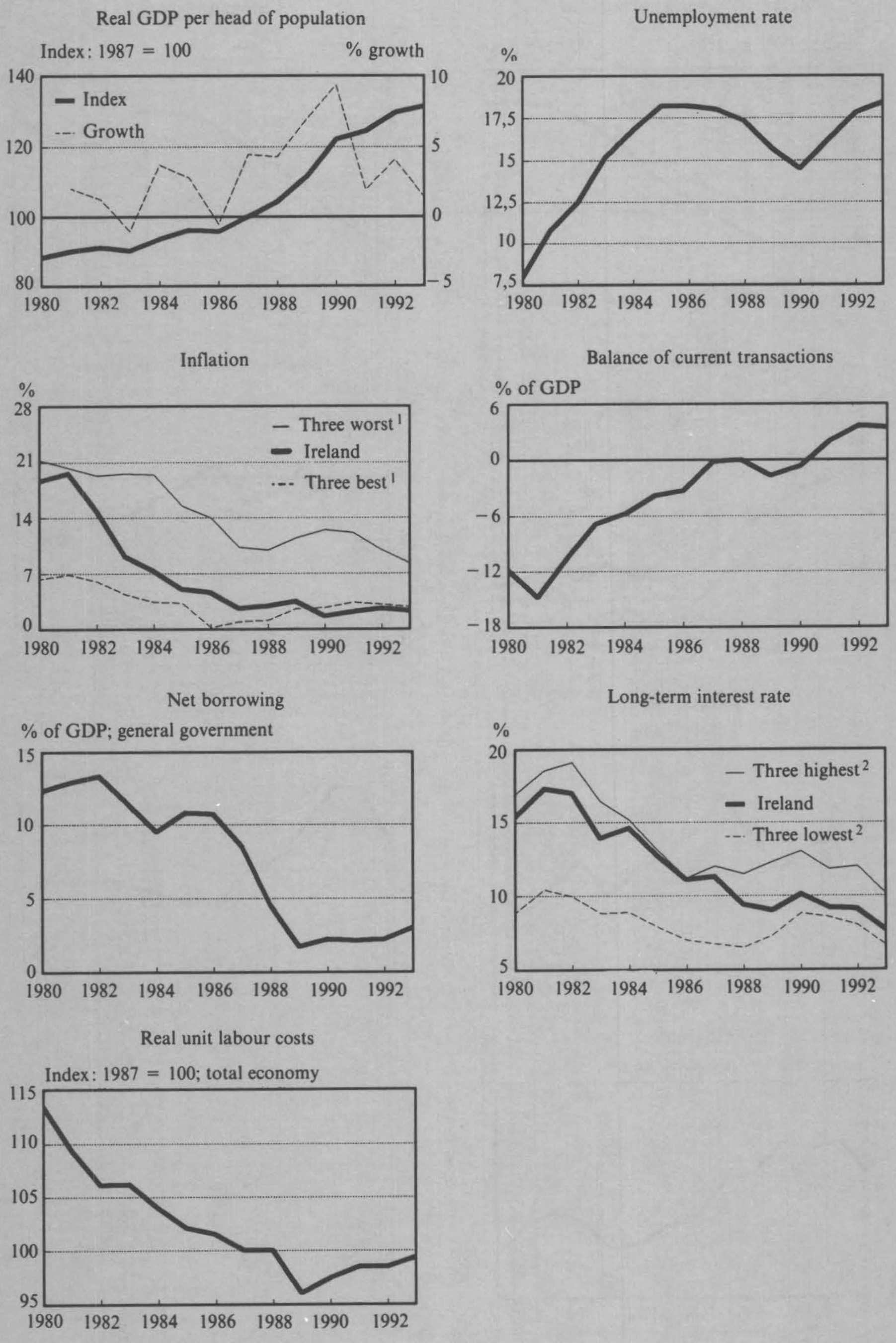
[1] Unweighted averages of the three best- or worst-performing Member States.
[2] Unweighted averages of the three highest or lowest rates in the Member States (excluding Greece and Portugal).
Source: Commission services, economic forecast (autumn 1993).

France



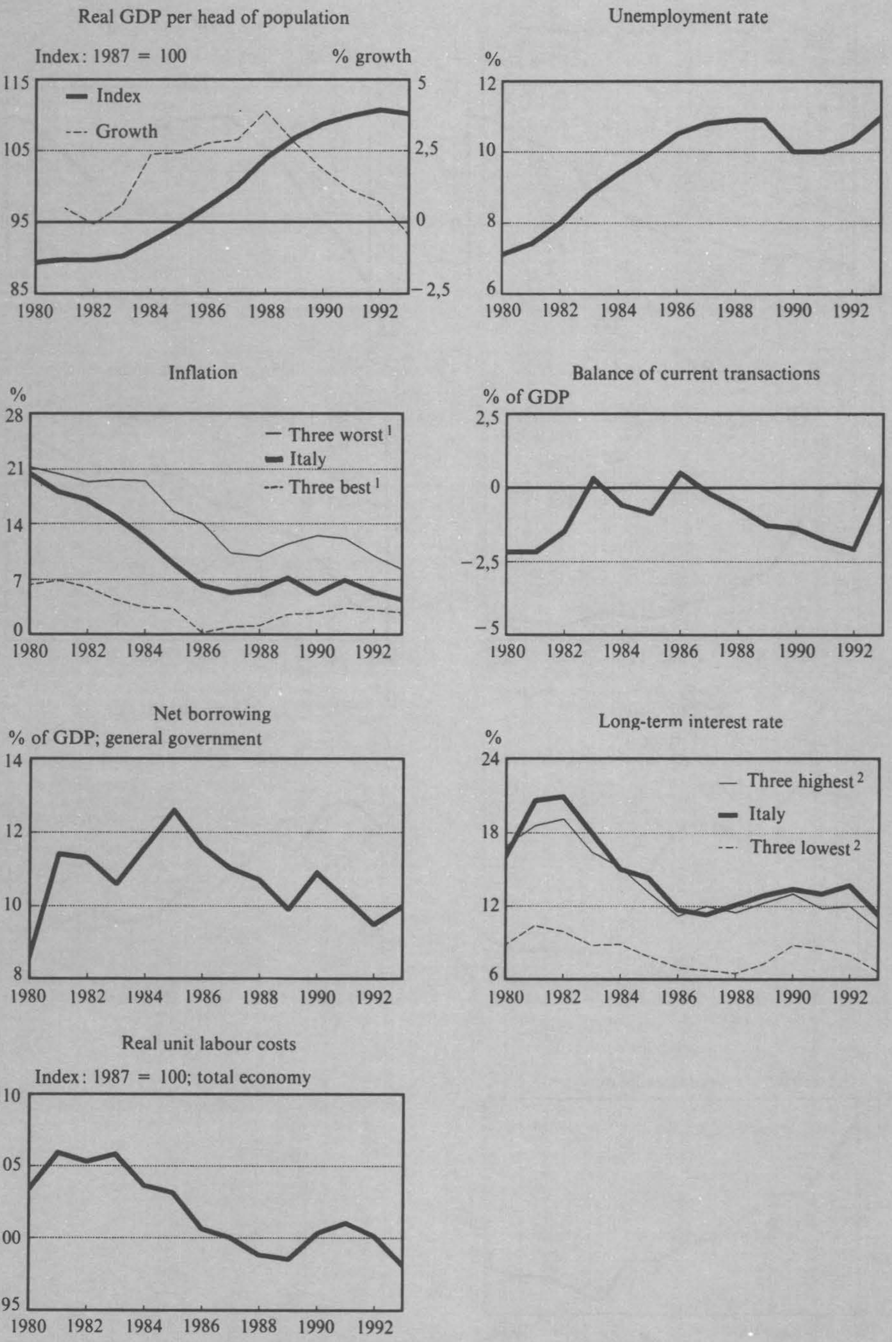
[1] Unweighted averages of the three best- or worst-performing Member States.
[2] Unweighted averages of the three highest or lowest rates in the Member States (excluding Greece and Portugal).
Source: Commission services, economic forecast (autumn 1993).

Ireland



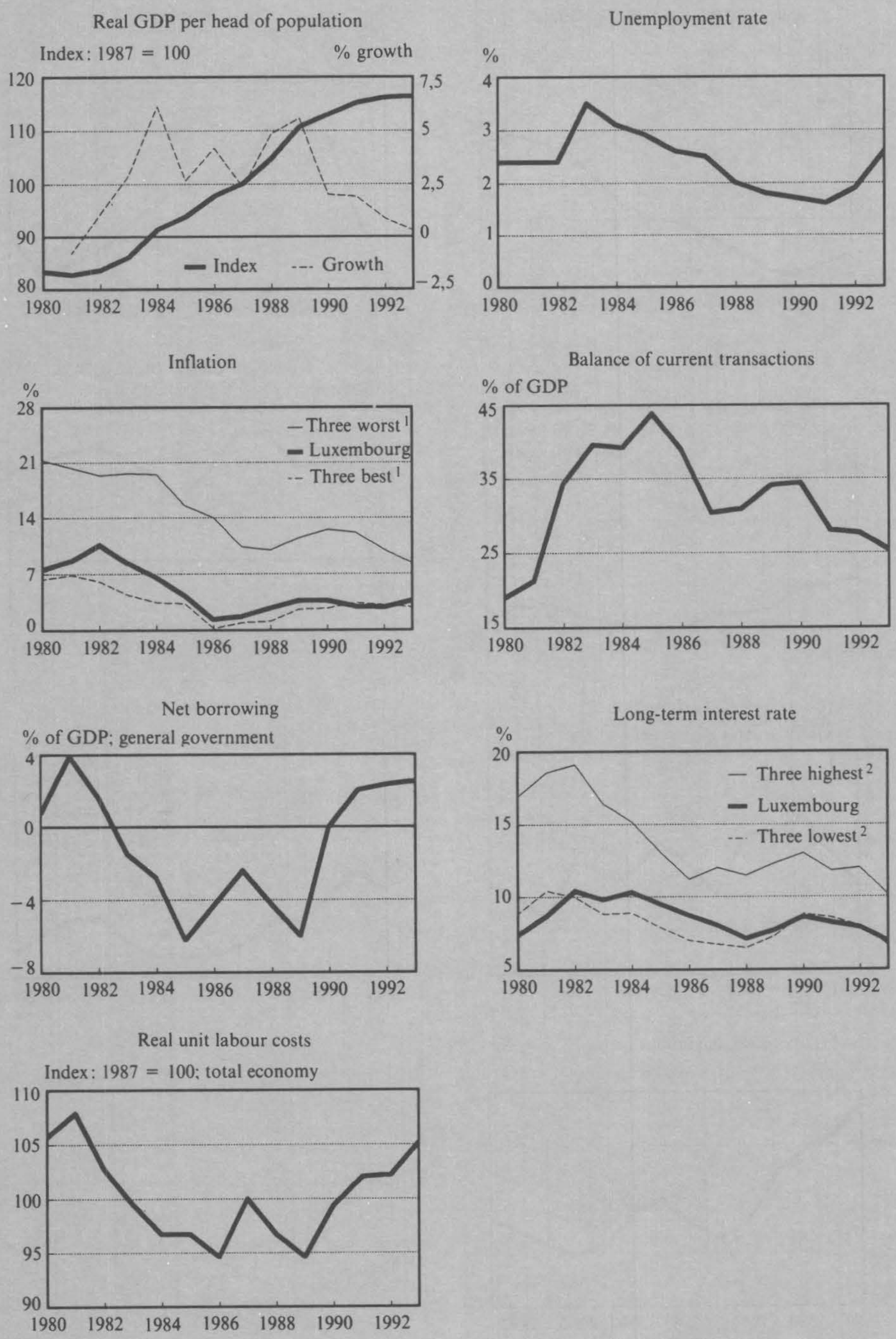
[1] Unweighted averages of the three best- or worst-performing Member States.
[2] Unweighted averages of the three highest or lowest rates in the Member States (excluding Greece and Portugal).
Source: Commission services, economic forecast (autumn 1993).

Italy



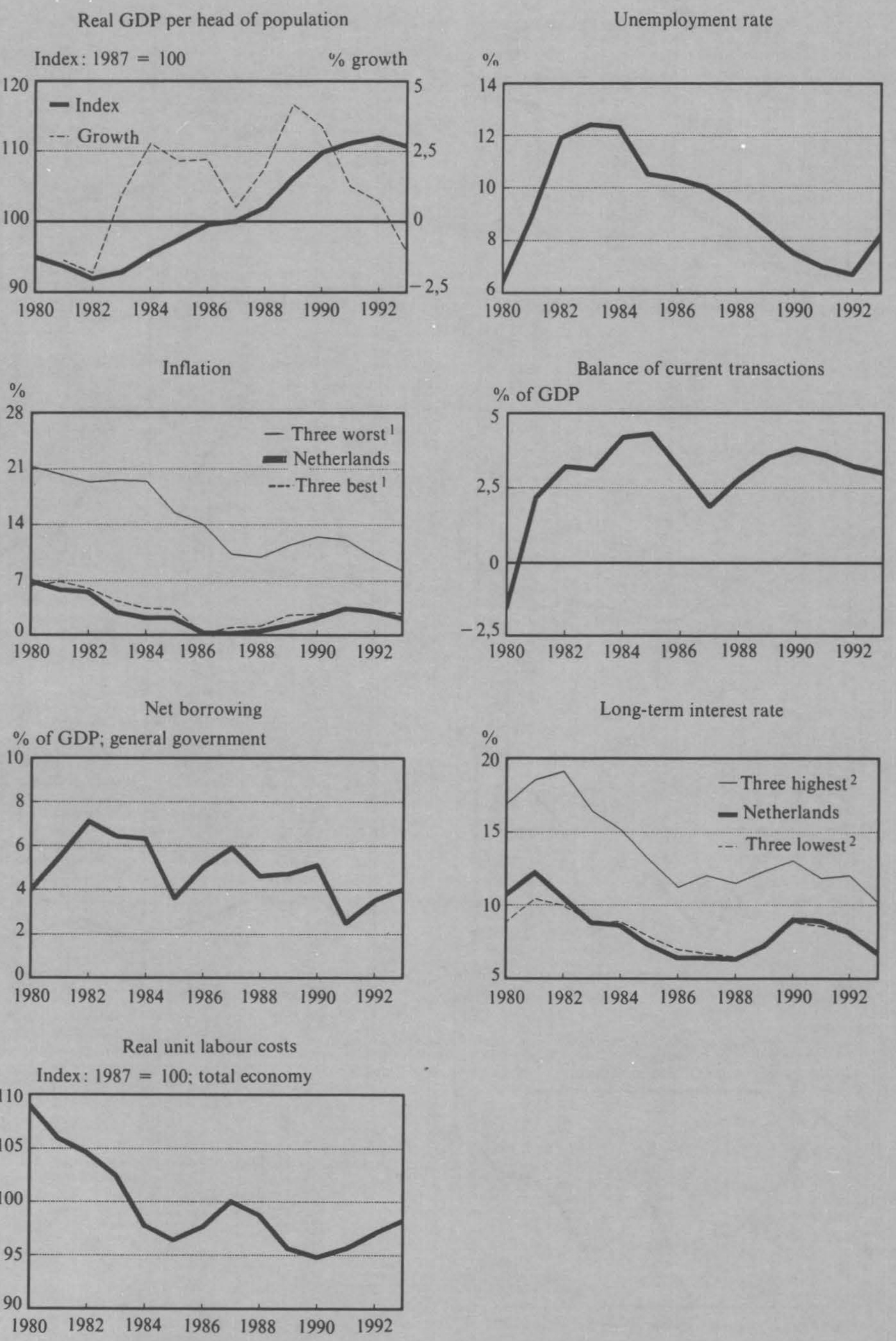
[1] Unweighted averages of the three best- or worst-performing Member States.
[2] Unweighted averages of the three highest or lowest rates in the Member States (excluding Greece and Portugal).
Source: Commission services, economic forecast (autumn 1993).

Luxembourg



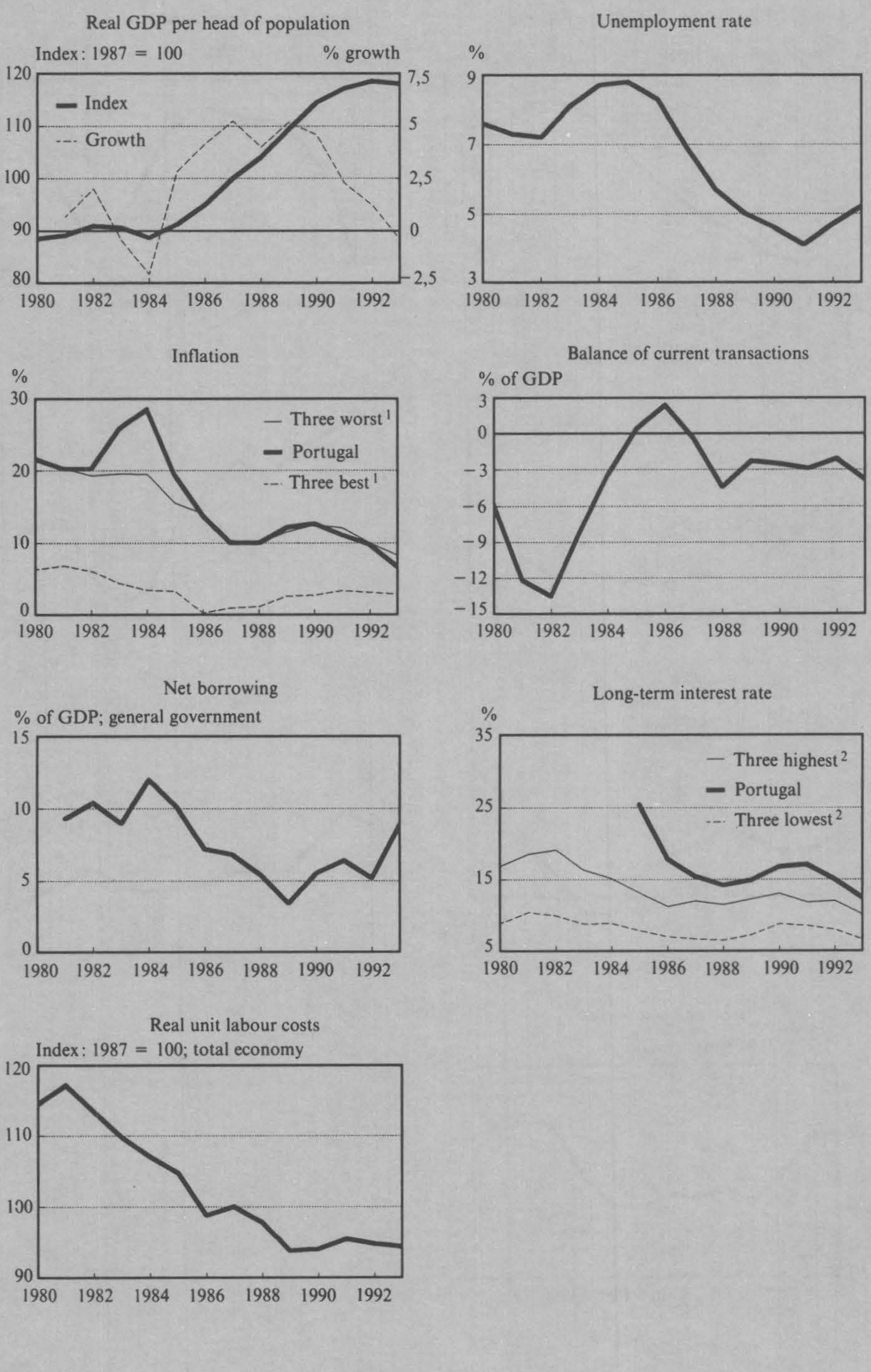
[1] Unweighted averages of the three best- or worst-performing Member States.
[2] Unweighted averages of the three highest or lowest rates in the Member States (excluding Greece and Portugal).
Source: Commission services, economic forecast (autumn 1993).

Netherlands



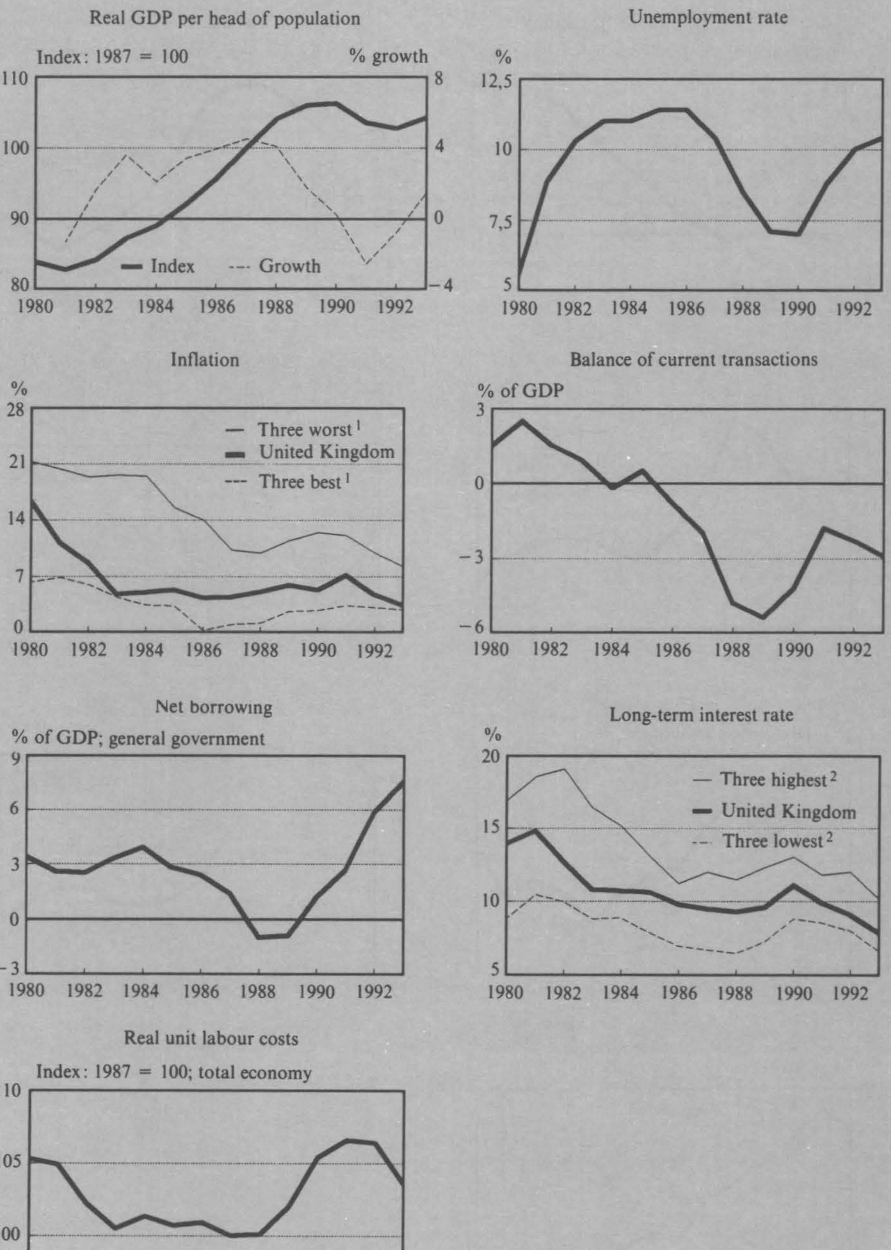
[1] Unweighted averages of the three best- or worst-performing Member States.
[2] Unweighted averages of the three highest or lowest rates in the Member States (excluding Greece and Portugal).
Source: Commission services, economic forecast (autumn 1993).

Portugal



[1] Unweighted averages of the three best- or worst-performing Member States.
[2] Unweighted averages of the three highest or lowest rates in the Member States (excluding Greece and Portugal).
Source: Commission services, economic forecast (autumn 1993).

United Kingdom



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